MONITORING COUNTRY PROGRESS IN CENTRAL AND EASTERN EUROPE & THE NEW INDEPENDENT STATES

USAID/ENI
Bureau for Europe & the New Independent States
U.S. Agency for International Development

Office of the Coordinator
for East European Assistance
Department of State

Office of the Coordinator
of U.S. Assistance To the New Independent States
Department of State

October 1998

EXECUTIVE SUMMARY

I. Introduction

The programs of U.S. assistance to Central and Eastern Europe (CEE) and to the New Independent States (NIS) of the former Soviet Union have been envisioned, since their inception, as short-term programs to jump start the countries of this strategically critical region on their way to political and economic transitions. It is essential, therefore, to monitor not only the impact of the U.S. assistance programs, but also the progress of the countries more generally to determine whether continued assistance is necessary or justified. This paper presents USAID/ENI's system for monitoring country progress with a focus on developing criteria towards graduation from USAID assistance.

II. Methodology

Country progress is analyzed in a sequence of steps for twenty-seven countries of the region. First, we look at the progress towards economic reforms and democratization. The promotion of both are the two pillars of USAID's program in the region. Progress on both fronts must reach a certain threshold before we can begin to consider graduation.

Next, we look at indications of sustainability; that is, macroeconomic performance and social conditions. Economic reforms need to translate into solid macroeconomic performance if they are to be sustained. Trends in social conditions need to be tracked as well to give us a pulse on the possibilities of economic and democratic reform fatigue as well as fiscal sustainability.

For most indicators, proposed graduation benchmarks are assigned. Failure of a country to meet a benchmark is intended to signal a yellow flag in the mind of the analyst; an aspect that may need to be examined more thoroughly if graduation is being considered on the basis of other evidence.

The indicators are drawn from standard, well-established data sources that are external to USAID. The primary sources are the EBRD, Freedom House, and the World Bank. Supplemental sources include the IMF, UNDP, UNICEF, and the Bureau of Census.

An important step of the process is the holding of annual inter-agency reviews--one for CEE, one for the NIS--of the data prior to the spring USAID program reviews. These inter-agency reviews are to serve as a reality check on the data and our interpretation of it.

III. Findings

The *Summary Figure* and *Summary Table* (below) suggest three country groups differentiated by progress towards economic and democratic reforms. The most clearly defined group consists of the Northern Tier CEE countries (less Slovakia). These countries are substantially out front, particularly in democratic reforms. At the other end of the reform spectrum are the laggards: three Central Asian Republics (Turkmenistan, Tajikistan, and Uzbekistan), Belarus, possibly Azerbaijan, and one CEE country recovering from war (Bosnia-Herzegovina). The middle group is the largest and includes the Southern Tier CEE countries, Russia, Ukraine, and other NIS.

The spread in progress between the three groups is more evident in democratization than it is in economic reforms. Seven of the Northern Tier countries now have democratic standards roughly comparable to many Western democracies. Turkmenistan ranks among the least democratic worldwide, and freedoms in Uzbekistan are not much greater. Linked to this trend is the observation that economic policy reforms in the region, relative to the standards in the industrial market economies, have far to go, even in the Northern Tier countries, notable recent progress in Poland and Hungary notwithstanding.

How does this picture compare with that of one year ago (as shown in *Monitoring Country Progress*, September 1997)? Three broad observations surface. One, the gap between the Northern Tier countries (less Slovakia) and the rest is more pronounced today; the Northern Tier countries look to be "pulling away." Nevertheless, the more recent picture also shows greater differentiation in progress within the Northern Tier CEE countries. Three, there looks to be an even closer correspondence today between economic and democratic reforms. Progress in both reform areas tend to go hand-in-hand, and more so now than in the past. Slovakia remains, however, the most notable exception to this trend having advanced relatively more in economic reforms than in democracy.

The growing gap between the transition leaders and laggards is attributed in no small part to considerably more policy backsliding over the past year, particularly in the NIS. Far and away the most significant deterioration in economic policy reforms has been in Russia. This deterioration reflects the virtual breakdown of the banking system and the financial markets in Russia following the August 17 devaluation of the ruble, the forced restructuring of the government's short-term debt, and the moratorium on commercial debt payments. Overall, by EBRD's estimate, eleven countries witnessed some deterioration in economic policy reforms from August 1997 to early September 1998. This compares to four countries backsliding the year before. The most significant progress in economic reforms in the past year has occurred in Tajikistan, followed by Azerbaijan and Moldova. Among the transition leaders, economic reform progress has been most evident in Poland and Hungary.

Trends in earlier years underscored the tendency for the pace of progress in economic reforms to be most evident among those countries at an intermediate stage in the transition process. Some of this was because progress in countries at a more advanced transition stage has tended to be slower in large part because the remaining reforms among the leaders are the most difficult and take the most time to implement and enforce. Events over the past year have amended these trends some. In particular, it is also apparent now that the intermediate reformers are more susceptible to backsliding in the current global context, and perhaps also that the easier reforms--the liberalization and stabilization measures that are done first--can be more easily eroded than the second and third round (institutional and structural) economic reforms. Similarly, sustaining the gains in liberalization and stabilization require progress in institutional and structural reforms.

Democratization trends are also sobering. From early 1997 to April 1998, ten countries witnessed a decrease in democratic freedoms, while only six experienced an increase. This reverses a more favorable trend in 1996 (when nine countries had an increase in freedoms and five a decrease). None of the backsliding occurred in the transition leaders. In fact, Lithuania made gains in four areas, and Slovenia, Estonia, and Poland each in one area. Broad-based gains also occurred in Bulgaria, Tajikistan, Georgia (though backsliding also occurred in public administration), and Slovakia. Broad-based losses occurred in Albania and several NIS: Russia, Ukraine, and Belarus, in particular. Only three countries--Kazakhstan, Moldova, and Georgia--experienced mixed results in democratic reforms; that is, gains in one or more areas alongside losses in others.

The subregional contrasts in progress towards economic and democratic reforms are reflected in divergences in macroeconomic performances and social conditions:

(1) In the Northern Tier CEE countries, sustained robust economic growth continues, five percent on average since 1994. Inflation continues to fall: 1998 inflation may be ten percent; down from twelve percent in 1997 and sixteen percent in 1996. Since 1995, fiscal deficits on average have remained equal to or less than the EU Maastricht target of three percent of GDP. Economic ties to the West continue to grow. Five countries have been invited to participate in the next round of negotiations towards EU membership. As much as sixty percent of Northern Tier exports now go to the EU.

Unemployment in the Northern Tier CEE countries is high but is falling, now more than one percentage point below the EU average (of eleven percent). Average income exceeds pre-transition income levels. Infant mortality has fallen more than thirty percent since 1989 and life expectancy for both males and females for the subregion as a whole has increased since 1989.

(2) For the Southern Tier CEE countries, strong economic growth in 1994-1996 gave way to a sharp contraction overall in 1997. Albania, Bulgaria, and Romania all experienced substantial economic contractions in 1997 (close to seven percent in each case). Romania's economy continues to languish and this will contribute to a very modest economic expansion in 1998 for the subregion overall. Inflation in the subregion in 1998, while considerably below the inflation rate of 205 percent at year-end 1997, will nevertheless remain too high at the end of 1998; likely close to thirty percent. This is largely because inflation in Romania may reach close to fifty percent. The high inflation has stemmed in part from significant macroeconomic imbalances: since 1994, fiscal deficits have averaged close to five percent of GDP, and since 1997, current account deficits have been higher still, six to seven percent of GDP.

Open unemployment in the Southern Tier increased to 12.4 percent in 1997, the highest of the transition subregions. Average income is still much below pre-transition income (seventy-six percent). The infant mortality rate has fallen eleven percent since 1989, but life expectancy trends are mixed: falling among males on balance since 1989; staying roughly the same for females. Secondary school enrollment dropped by sixteen percent from 1990 to 1995.

(3) 1997 represented the first year of economic growth for the NIS on average since the transition began. This was largely because Russia's economy registered its first expansion in 1997 since communism's collapse; albeit at a very modest 0.8 percent. However, with the collapse of the Russian economy and its spillover to the region, overall expansion will not be repeated in 1998. Preliminary estimates have Russia's economy contracting in 1998 anywhere from four to six percent. The dramatic fall of prices of commodities, such as oil and metal, are also contributing to slower export growth and with it overall economic growth in several resource rich NIS. Progress in attaining and maintaining reasonable inflation rates is decidedly mixed. Overall inflation in the NIS, however, has increased dramatically in 1998 due primarily to Russia (where the annualized inflation rate could be 500 percent at end-year 1998). Macroeconomic imbalances are very high: six of the nine transition countries likely to incur a fiscal deficit greater than five percent of GDP in 1998 are NIS; most of the unsustainably high current account deficits are in the NIS.

Average official income has dropped by almost fifty percent in the NIS since communism's collapse (and it continues to fall). Of the transition subregions, income inequality was the greatest in the NIS at the outset of the transition and has increased the most since (by almost fifty percent from 1989 to 1996). Income inequality in some of these countries--Russia, Kyrgyzstan, and Ukraine, in particular--now compares to that found in the most unequal economies worldwide. By one count, one of every two persons in the NIS in 1993-1995 were poor. This compares to eleven percent and twenty-four percent of persons in the Northern Tier and Southern Tier CEE countries, respectively. The infant mortality rate has dropped by six percent from 1989 to 1996, but so has life expectancy. The drop in life expectancy is particularly dramatic for males in the NIS, but, unlike in CEE, it has also dropped for females.

IV. Concluding Remarks

Making appropriate decisions on the magnitude and duration of U.S. assistance to countries of the ENI region requires consideration of much more than country progress and need. Other key factors include: (1) the strategic importance of the country to the U.S.; (2) the importance of the recipient country to U.S. citizens; and (3) the effectiveness of particular assistance activities.

The first two factors are considered by USAID and by the State Department-based Coordinators for U.S. Assistance to both CEE and the NIS in setting annual assistance levels for each country. The effectiveness of the assistance is assessed through the annual collection of data on established performance targets and through occasional project evaluations and sectoral impact evaluations.

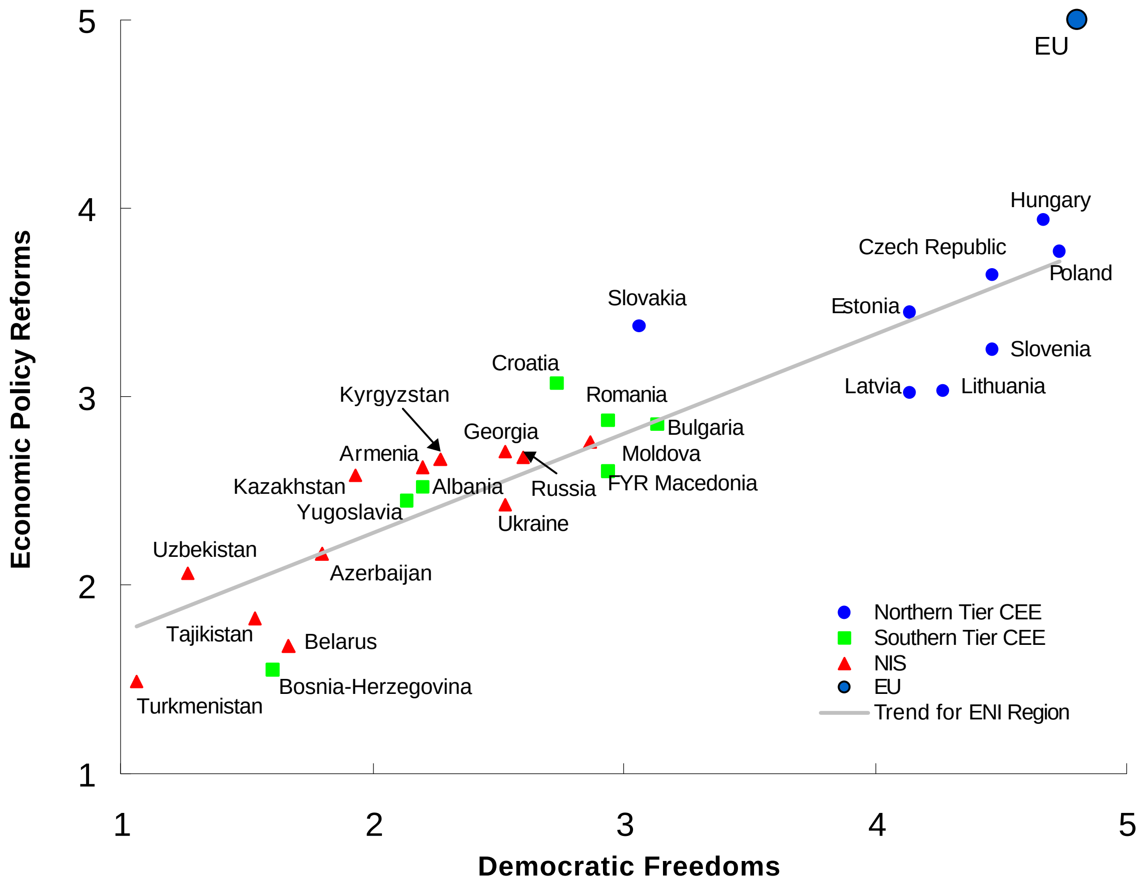
Within this broader policy context, USAID will collect, analyze, and report on the country performance indicators semi-annually. These data will be provided to the State Department-based Coordinators for U.S. Assistance to CEE and the NIS and discussed with them, along with assessments of the other three factors listed above, when country planning levels are determined each winter. Particular country levels will likely be shaped in part by whether a given country falls into one of three categories, based on the analysis of country performance indicators:

(1) Countries ranked near the top of the list are obvious candidates for earlier graduation.

(2) Countries near the bottom of the list may fall into one of three contrasting categories: (i) those where assistance is least likely to be effective, in which case it may make sense to close those programs down altogether or to keep highly targeted funding at minimal levels until their commitment to reform increases; (ii) those where reform now appears likely but requires greater resources; or (iii) those which possess characteristics that match well with the Agency's priorities for sustainable development programs.

(3) Countries in the middle of the list are likely candidates for continuing programs through existing funding mechanisms, as long as the assistance is effective and Congress continues to appropriate funds for this purpose. From these countries we would expect to see the next group of candidates to graduate.

Summary Figure. Economic Policy Reforms and Democratic Freedoms in Central & Eastern Europe and the New Independent States: 1998



Ratings of democratic freedoms are from Freedom House, Nations in Transit 1998 (October 1998, forthcoming), and assess reforms to April 1, 1998. With 1 exception, economic policy reform ratings are from EBRD, Transition Report 1998 (November 1998, forthcoming), and cover events through early September 1998; economic policy reform rating for Yugoslavia is from Freedom House (October 1998). Ratings are based on a 1 to 5 scale, with 5 representing most advanced.

Summary Table. Economic Policy Reforms and Democratic Freedoms in Central & Eastern Europe and the New Independent States: 1998

Economic Policy			Democratic Freedoms		
Country	**Rating (1 to 5)**	**Ranking**	**Country**	**Rating (1 to 5)**	**Ranking**
Hungary	3.9	1	Poland	4.7	1
Poland	3.8	2	Hungary	4.7	1
Czech Republic	3.7	3	Czech Republic	4.5	3
Estonia	3.5	4	Slovenia	4.5	3
Slovakia	3.4	5	Lithuania	4.3	5
Slovenia	3.3	6	Estonia	4.1	6
Croatia	3.1	7	Latvia	4.1	6
Lithuania	3.0	8	Bulgaria	3.1	8
Latvia	3.0	8	Slovakia	3.1	8
Romania	2.9	10	Romania	2.9	10
Bulgaria	2.9	10	FYR Macedonia	2.9	10
Moldova	2.8	12	Moldova	2.9	10
Georgia	2.7	13	Croatia	2.7	13
Russia	2.7	13	Russia	2.6	14
Kyrgyzstan	2.7	13	Georgia	2.5	15
Armenia	2.6	16	Ukraine	2.5	15
FYR Macedonia	2.6	16	Kyrgyzstan	2.3	17
Kazakhstan	2.6	16	Albania	2.2	18
Albania	2.5	19	Armenia	2.2	18
Yugoslavia	2.4	20	Yugoslavia	2.1	20
Ukraine	2.4	20	Kazakhstan	1.9	21
Azerbaijan	2.2	22	Azerbaijan	1.8	22
Uzbekistan	2.1	23	Belarus	1.7	23
Tajikistan	1.8	24	Bosnia-Herzegovina	1.6	24
Belarus	1.7	25	Tajikistan	1.5	25
Bosnia-Herzegovina	1.6	26	Uzbekistan	1.3	26
Turkmenistan	1.5	27	Turkmenistan	1.1	27

	Economic Policy Rating (1 to 5)	Democratic Freedoms Rating (1 to 5)
CEE & NIS	2.7	2.8
Northern Tier CEE	3.7	4.5
Southern Tier CEE	2.7	2.9
NIS	2.5	2.3
European Union	5.0	4.8
OECD	--	4.6

Ratings of democratic freedoms are from Freedom House, Nations in Transit 1998 (October 1998, forthcoming), and assess reforms to April 1, 1998. With 1 exception, economic policy reform ratings are from EBRD, Transition Report 1998 (November 1998, forthcoming), and cover events through early September 1998; economic policy reform rating for Yugoslavia is from Freedom House (October 1998). Ratings are based on a 1 to 5 scale, with 5 representing most advanced.

MONITORING COUNTRY PROGRESS

I. Introduction

The programs of U.S. assistance to Central and Eastern Europe (CEE) and to the New Independent States (NIS) of the former Soviet Union have been envisioned, since their inception, as short-term programs to jump start the countries of this strategically critical region on their way to political and economic transitions. The objective is to help move these countries far enough along the road to becoming market-based democracies that they can complete the journey themselves.

It is, therefore, essential to monitor both the impact of the U.S. assistance programs themselves to maximize their effectiveness (*program impact monitoring*), as well as the progress of the countries more generally to determine whether continued assistance is necessary or justified (*country progress monitoring*). Program impact monitoring is done through a system of setting results targets and annually monitoring progress toward them and through less frequent special field evaluations. This paper presents USAID/ENI's system for monitoring country progress in twenty-seven countries of the region.

Country progress monitoring is done in part to determine whether the assistance program can be terminated either because: (a) the country is well launched on its way to a successful transition and cessation of assistance will no longer jeopardize that transition (i.e., graduation); or (b) the country is making so little progress that significant resources will have little impact. Monitoring is done semi-annually and results are shared with the State Department-based Coordinators for U.S. Assistance to each of the two regions. The Coordinators are charged with, among other things, determining the magnitude and duration of these transition assistance programs.

Section II below highlights the methodology. This is followed in Section III by analyses in each of the major areas examined: (a) **economic policy reforms**; (b) **democratization**; (c) **macro-economic performance**; and (d) **social conditions**. Section IV concludes. *Appendix I* elaborates on the rating schemes of the economic policy reform and democratization indicators. *Appendix II* presents in graphs evidence of widely divergent transition paths among subregions of the transition economies.

II. Methodology

Market-oriented reforms and democratization are the two pillars of USAID's program in the ENI region.[1] The challenge of this analysis thus is essentially to make assessments of the progress on

[1] USAID assistance to ENI countries is funded through the Support for East European Democracy Act (SEED) and the Freedom Support Act (FSA), the latter applying to the NIS. The SEED Act has two goals: the promotion of democracy and

both fronts, with a particular focus on the sustainability of reforms.

Country progress is hence analyzed in a sequence of steps drawing from standard, well-established data sources that are external to USAID. First, we look at the progress towards economic reforms and democratization. Progress on both fronts must reach a certain threshold before we can begin to consider graduation.

Economic policy reforms are assessed by drawing from EBRD's rating scheme of transition indicators, and supplemented by a similar scheme from Freedom House. Progress in democratic freedoms is determined from Freedom House's rating of civil liberties and political rights, and from an effort on its part to further disaggregate the measurement of such freedoms.

Next, we look at indications of sustainability. Economic reforms need to translate into solid macroeconomic performance. If the implementation of economic policies is determined to be sufficient in a particular country and yet the economy is performing poorly, then they are not there yet. We might expect improved performance to kick in with a lag. But evidence of good macroeconomic performance would give us more confidence that the reformed economy is self-sustaining.

Furthermore, it is important to underscore that acceptable progress in the reforms must precede good macroeconomic performance. A cross-country snapshot might show one economy outperforming another in part because painful reforms have been avoided in the former. Yet, this is hardly sustainable.

The macroeconomic performance indicators also provide a check on the comprehensiveness of the economic reform indicators. For example, fiscal reform is likely not adequately addressed in the current mix of economic reform indicators. Yet, insufficient fiscal reform is likely to surface in the form of bloated fiscal deficits, and this *is* being tracked as an economic performance indicator.

Another means to measure the sustainability of both economic and political reforms is to assess trends in social conditions. This is largely the concern of reform fatigue. The populace may not continue to support difficult reforms if the standard of living for many declines drastically. It may not be good enough, in other words, to have sound economic policies in place, solid macroeconomic performance, and extensive political and civil liberties, if a significant proportion of the population is losing out on balance.

Trends in social conditions also link to fiscal sustainability. Deteriorating social conditions may have a significant impact on social expenditures. Similarly, demographic changes may have substantial repercussions on pension systems.

Country progress is weighed throughout this report with population-weighted measures of progress of three subregions among the transition economies as well as with comparators outside

---

a market-oriented economy. The FSA objectives are broader in scope, including the transition goals of the SEED Act as well as those focused more directly on humanitarian, social, environmental, and trade and investment conditions.

the region. The Northern Tier Central and Eastern Europe consists of Poland, Hungary, Slovenia, the Czech Republic, Slovakia, Estonia, Latvia, and Lithuania; the Southern Tier CEE consists of Romania, Bulgaria, Croatia, the FYR Macedonia, Albania, and, when data are available, Bosnia-Herzegovina, and Yugoslavia; and the New Independent States consist of the countries formed from the dissolution of Soviet Union less Latvia, Lithuania, and Estonia.

For most indicators, proposed graduation benchmarks are assigned. Some are more arbitrary than others and need to be held to debate. Should a country fail to meet a benchmark, this should signal a yellow flag in the mind of the analyst; an aspect that may need to be examined more thoroughly if graduation is being considered on the basis of other evidence. The number of benchmarks a country needs to achieve should vary according to context.

An important step of the process is the holding of annual reviews—one for CEE, one for the NIS—with area specialists from U.S. government agencies prior to USAID's spring program review. Soliciting such expert opinion serves as a reality check on the data and our interpretation of it.

Finally, it merits explicitly recognizing that what is occurring in the region is unprecedented, and that there is little if any theoretical and/or empirical basis for devising precise thresholds of reform sustainability. Further, it is reasonable to assume that there is more than one acceptable transition route, or, what may amount to the same, many possible varieties of sustainable market-oriented democracies. This exercise, in short, is likely to be as much art as it is science, and it is important to place the results in this context.

III. Analysis

A. Economic Policy Reforms

Progress towards economic policy reforms is primarily assessed from indicators drawn from the EBRD's annual *Transition Report*. Sufficient progress must entail both an adequate threshold of reform as well as a favorable trend over time; that is, no significant policy backsliding.

Nine indicators are taken from EBRD's *Transition Report 1998* (November 1998, forthcoming) and compared with comparable indicators from EBRD's previous four annual reports: (1) price liberalization; (2) trade and foreign exchange reforms; (3) small-scale privatization; (4) large-scale privatization; (5) enterprise restructuring policy; (6) banking reform; (7) non-bank financial reforms (capital markets); (8) competition policy; and (9) investment-related legal reforms (commercial law framework). In addition, an environmental policy reform indicator is created from several indicators analyzed in EBRD (November 1997) and added to the mix of economic reform indicators.

The indicators are measured on a one-to-five scale, with gradations in between.[2] A five represents

[2] In earlier *Transition Reports*, the EBRD assigned a 4* to the highest threshold and provided a separate description of the

standards and performance norms typical of advanced industrial economies. In general, depending on the particular indicator, a three or a four may very well be the threshold that we seek. Descriptions of the rating categories are provided in *Appendix I*. Included is an elaboration of the components that went into the environmental policy reform indicator.

These indicators focus on critical economic reform aspects of liberalization and institution-building in the transition process. Such reforms provide much of the overall enabling environment that is required for the emergence of a vibrant and sustainable market economy. While we review the reforms in stages below, it is important to recognize the existence of strong complementarities among them all, and the possibilities for synergism that derive from implementation of the total policy package. The other side to this is the possibility that insufficient progress in one reform aspect may undermine the potential gains from progress of another.

First Round Reforms. Following EBRD's lead (in its *Transition Report 1995*), we group these indicators according to three stages in the reform process. The first round reforms consist of liberalization of prices, external trade and currency arrangements, and privatization of small-scale units.

Price liberalization focuses on the decontrolling of wages and product market prices, including key infrastructure products such as utilities and energy, and the phasing out of state procurement at non-market prices. ***Trade and foreign exchange reforms*** focus on the removal of trade restrictions (export tariffs, quantitative and administrative import and export restrictions), progress towards membership in the WTO, and improving access to foreign exchange (current and capital account convertibility). ***Small-scale privatization*** includes small firms, small farms and plots of land, and housing. Alongside the growth of new firms, privatization is an essential aspect towards restructuring the economy into one that is private-sector driven. Price liberalization provides the appropriate incentives through market-based prices to better maximize efficiency. Trade and foreign exchange reforms provide further discipline for the private sector through global competition, as well as providing domestic firms with a greater capacity to compete.

These first round reforms, which require relatively little institution building, tend to be the easiest to do. In fact, in CEE they have generally been adopted rapidly and quite thoroughly. By mid-1995, arguably all CEE countries but Bulgaria, Romania, and Bosnia-Herzegovina had advanced significantly towards achieving these reforms.[3] Moreover, many Northern Tier countries--Hungary, Poland, Slovakia, and Slovenia, in particular--have achieved policy standards towards small-scale private enterprise and in trade and foreign exchange systems that are comparable to those of the advanced industrial economies.

This progress in CEE does not preclude minor setbacks along the way. For example, a handful of countries, including Slovakia, Slovenia, the Czech Republic, and Macedonia, resorted to temporary wage controls in 1997 in the face of fiscal pressures. Croatia tightened capital controls in the spring

---

criteria to achieve that level of progress. For simplicity, their 4* (which is now a 4+) becomes our 5 . All other "+"s and "-"s are measured by adding or subtracting a "0.3", respectively.

[3] Yugoslavia is not included in EBRD's rating scheme.

of 1998 to stem an excessive inflow of foreign capital which in turn was fueling excessive domestic credit growth. The Czech Republic and Slovakia both implemented import surcharges in 1997 to ward against growing current account deficits and to maintain the value of the domestic currencies.

Among the NIS, in contrast, perhaps only Georgia, Kyrgyzstan, and more recently Kazakhstan have progressed sufficiently in first round reforms. Significant backsliding has very recently occurred in Russia in price liberalization and trade and foreign exchange reforms. Capital and exchange controls were levied, a de facto multiple exchange rate came into being, and price controls were re-introduced in parts of Russia. Such deterioration underscores that early gains in liberalization and stabilization may be difficult to sustain in the absence of supporting institutional and structural reforms of the second and third rounds. First round reform backsliding also occurred in Ukraine, Uzbekistan, and Belarus. *Table 1* below shows the status of these reforms as of early September 1998. *Appendix I* describes the rating categories.

Second Round Reforms. These reforms focus on large-scale privatization and enterprise restructuring. Measuring progress in ***large-scale privatization*** includes assessing the extent of the transfer of assets to the private sector, but also the extent of outside ownership and effective corporate governance of such entities. ***Enterprise restructuring reforms*** address effective corporate governance in large part through government actions to tighten credit and subsidy policy at the firm level, enforce bankruptcy legislation, and break up dominant firms. Such reforms, in other words, provide some of the financial discipline needed for vibrant growth of the private sector.

Not surprisingly, progress towards these reforms has been slower than that of the first round reforms in no small part because they require more preparation to build political consensus as well as to create the infrastructure to implement them. In fact, as highlighted in *Table 2*, it may be that only Hungary, the Czech Republic, and Estonia have progressed sufficiently in these regards, though Slovakia and Poland are not far behind.

Nevertheless, there have been some encouraging trends throughout much of the region in large-scale privatization. Many countries have shifted away from privatization through buy-outs from managers and employees and away from mass voucher programs, and towards greater foreign participation through cash sales and international tenders. While Hungary continues to be out front in this regard, other countries have recently followed suit, including most recently, Georgia, Kazakhstan, Latvia, Lithuania, Poland, Romania, and Ukraine.

Restructuring large loss-making enterprises, either through privatization and/or liquidation, remains a major challenge, however, in most transition countries. Furthermore, good corporate governance continues to be hindered by the prevalence of "soft" budget constraints, and, particularly in the NIS, by pervasive corruption and organized crime.

Third Round Reforms. These reforms are the most challenging, and progress is least evident in this domain. The focus here is on banking reform, private non-bank financial institutions, competition policy, investment-related legal reforms, and environmental policy.

Banking reform includes progress towards the establishment of bank solvency, well-functioning bank competition coupled with interest rate liberalization, financial deepening and extensiveness of private sector lending, and effective prudential supervision, with movement of laws and regulations towards BIS standards.

Non-bank financial reforms include the development and deepening of securities exchanges, investment funds, private insurance and pensions funds, leasing companies, and associated regulatory framework, with movement of laws and regulations towards IOSCO standards.

The financial system undergirds the market economy. The private sector cannot grow and develop without a sound financial sector. It provides the capital to grow. It provides the discipline towards good corporate governance. Nor can there exist a stable macroeconomic framework without a sound financial system, given its importance in overall monetary management. Moreover, an unstable financial sector can lead to crisis, and, in fact, most of the significant economic setbacks that have occurred in the transition economies have been largely triggered by financial crisis. Russia is the most recent example, though economic crises in Bulgaria and Albania in 1996-1997, and backsliding in the Czech Republic in 1997 apply as well.

Competition policy focuses on the development of legislation and institutions to facilitate the entry of firms, existing or potential, into existing markets. This includes the promotion of a competitive environment through enforcement actions to reduce the abuse of market power by dominant (or non-competitive) firms. The more competitive is the market structure, the greater is the efficiency of the firm.

Investment-related legal reforms include the development of clear investment or commercial laws which do not discriminate between domestic and foreign investors, and which are well administered and supported judicially. These laws provide much of the rule of law framework so critical for the growth of the private sector. Three laws--bankruptcy, pledge or collateral, and company law --and the implementation of these laws are the focus of EBRD's legal reforms rating.

Finally, ***environmental policy reforms*** include four components: (a) the degree of adherence to six key international environmental treaties; (b) progress in air and water standards; (c) progress in preparing and implementing national environmental action plans; and (d) an assessment of the extent to which environmental financial incentive mechanisms are used. Progress in environmental reforms contributes directly to progress in other economic reform areas.

Progress is slowest in the third round reforms (*Table 3*). In particular, financial reforms, both in banking and capital markets, and competition policy (as well as the second round reforms pertaining to enterprise restructuring) tend to lag the most throughout CEE and the NIS. Hungary, followed by Poland and the Czech Republic are significantly out front of the rest in terms of progress towards implementing these third round reforms.

The challenge as well as the urgency to reform the financial sectors in the transition economies has increased in the wake of the Asian and Russian crises. In particular, the banking sectors are exposed to the risks from devaluations (particularly those with a large proportion of short-term foreign debt in their portfolios), and, more generally, to the growing likelihood of failing businesses.

Trends over Time in Economic Policy. The EBRD ratings (of *Tables 1-3*) give us a snapshot of the cumulative progress in reforms through early September 1998. *Table 4* below shows how these ratings compare over time, since 1994. Where are the reforms on track? Where has there been backsliding?

Only one country, Belarus, is farther behind in economic reforms today than in 1994. Partial or temporary setbacks in other countries, however, have not been uncommon. On the contrary, most country transition paths have been characterized by starts and stops and occasional backsliding. In the past year, from August 1997 to September 1998, in fact, backsliding in economic reforms has been more prevalent than in the previous four years. With Russia's economic crisis still unfolding, there may be pressures, particularly in the NIS, for further backsliding for some time to come.

Since August 1997, eleven countries have witnessed some deterioration in economic policy reforms. Far and away the most significant deterioration has been in Russia, where backsliding occurred in four areas: trade & foreign exchange; nonbank financial reforms; bank reforms; and price liberalization. This deterioration reflects the virtual breakdown of the banking system and the financial markets in Russia following the August 17 devaluation of the ruble, the forced restructuring of the government's short-term debt, and the moratorium on commercial debt payments.

Latvia saw deterioration in two areas: bank reforms and legal reforms. Three countries--Romania, Slovakia, and Belarus--saw mixed progress in the past year; that is, gains occurred in one reform area while backsliding happened elsewhere.

Ten countries showed progress overall from mid-1997 to the present. The most significant progress occurred in Tajikistan, followed by Azerbaijan and Moldova. Much of this progress was in first round reforms, particularly in Tajikistan, though financial and legal reforms made headway in Moldova and Azerbaijan as well.

Among the transition leaders, progress was most evident in Poland and Hungary. Here, significant progress was made in addressing the very difficult institutional reforms associated with the financial sector and corporate governance. In general, progress tends to be less evident in countries at a more advanced transition stage in part because the remaining reforms among the leaders are the most difficult and take the most time to implement and enforce. However, it is also true that the slower reformers are more susceptible and vulnerable to backsliding in the current global context, and that the easier reforms--the liberalization and stabilization measures that are done first--can also be easily eroded.

For the transition countries as a whole, since 1994, the reform area which has witnessed the greatest progress is in small-scale privatization. In two areas, price liberalization and capital market reforms, backsliding has outweighed progress since 1994. This is primarily attributed to recent events in

Russia.

Economic Reform Ratings Compared: EBRD vs. Freedom House. *Table 5* provides a similar economic policy rating scheme from Freedom House to that of the EBRD. *Table 6* compares the results of the two schemes. Freedom House in its *Nations in Transit 1998* (October 1998) assesses economic reform by weighing three broad aspects: (1) progress towards ***privatization*** (the scope and type of privatization; the extent of public awareness and support) ; (2) the development of ***macroeconomic policy*** and reform of the state (reforms in tax and public expenditure, banking and capital markets, and exchange rate policy); and (3) ***microeconomic policy*** to encourage enterprise development (commercial law development, judicial reform, price liberalization, competition policy, trade and investment reform, and energy sector reform). The ratings represent progress of the reforms as of early April 1998.

Two salient observations emerge from the comparison of the results of the two schemes. First, the overall rankings of the progress of the countries are generally consistent. The leaders and laggards in both schemes generally coincide. Hungary, Poland, the Czech Republic, Estonia, and Slovenia are at the top; Turkmenistan, Bosnia-Herzegovina, Belarus, Tajikistan, Uzbekistan, and Azerbaijan have the furthest yet to go by both accounts. Where differences in rankings occur, much of this can likely be attributed to differences in time period (the EBRD ratings are more current), and differences in emphases (Freedom House weighs privatization, for example, more heavily). The greatest discrepancy in ranking between the two schemes is found in the case of Romania. Freedom House ranks it sixteenth (alongside Albania and Kazakhstan), while the EBRD ranks it tenth (with Bulgaria).

Secondly, Freedom House finds a much more pronounced gap between the reform leaders and the rest. Moreover, according to Freedom House, Slovakia essentially is not among the reform leaders; that is, economic reforms in Slovakia significantly trail progress found in the other Northern Tier CEE countries. Reforms in Slovakia are comparable to those in Kyrgyzstan by Freedom House measures. In contrast, Slovakia is further along the economic reform path than is Slovenia, Latvia, and Lithuania, according to the EBRD.

Table 1. First Round Economic Policy Reforms

Country	Small-Scale Privatization	Price Liberalization	Trade & Foreign Exchange	Average
Hungary	5.0	3.3	5.0	4.4
Poland	5.0	3.3	5.0	4.4
Slovakia	5.0	3.0	5.0	4.3
Slovenia	5.0	3.0	5.0	4.3
Croatia	5.0	3.0	4.0	4.0
Czech Republic	5.0	3.0	4.0	4.0
Estonia	5.0	3.0	4.0	4.0
Albania	4.0	3.0	4.0	3.7
FYR Macedonia	4.0	3.0	4.0	3.7
Georgia	4.0	3.0	4.0	3.7
Kazakhstan	4.0	3.0	4.0	3.7
Kyrgyzstan	4.0	3.0	4.0	3.7
Latvia	4.0	3.0	4.0	3.7
Lithuania	4.0	3.0	4.0	3.7
Moldova	3.3	3.0	4.0	3.4
Romania	3.3	3.0	4.0	3.4
Armenia	3.0	3.0	4.0	3.3
Bulgaria	3.0	3.0	4.0	3.3
Azerbaijan	3.0	3.0	3.0	3.0
Russia	4.0	2.7	2.3	3.0
Ukraine	3.3	3.0	2.7	3.0
Tajikistan	2.3	3.0	2.7	2.7
Uzbekistan	3.0	2.0	1.7	2.2
Bosnia-Herzegovina	1.0	3.0	2.0	2.0
Belarus	2.0	2.0	1.0	1.7
Turkmenistan	2.0	2.0	1.0	1.7
CEE & NIS	3.8	2.8	3.1	3.2
Northern Tier CEE	4.9	3.2	4.8	4.3
Southern Tier CEE	3.3	3.0	3.9	3.4
NIS	3.6	2.7	2.5	2.9
Industrial Countries	5.0	5.0	5.0	5.0
Benchmarks	4.0	3.0	4.0	3.7

Note: On a 1 to 5 scale, with 5 being most advanced. All regional averages in this report are population-weighted.

Source: EBRD, *Transition Report 1998* (November 1998, forthcoming).

Table 2. Second Round Economic Policy Reforms

Country	Large-Scale Privatization	Enterprise Restructuring	Average
Hungary	4.0	3.3	3.7
Czech Republic	4.0	3.0	3.5
Estonia	4.0	3.0	3.5
Slovakia	4.0	2.7	3.4
Poland	3.3	3.0	3.2
Slovenia	3.3	2.7	3.0
Croatia	3.0	2.7	2.9
Latvia	3.0	2.7	2.9
Lithuania	3.0	2.7	2.9
Bulgaria	3.0	2.3	2.7
Georgia	3.3	2.0	2.7
Russia	3.3	2.0	2.7
Armenia	3.0	2.0	2.5
FYR Macedonia	3.0	2.0	2.5
Kazakhstan	3.0	2.0	2.5
Kyrgyzstan	3.0	2.0	2.5
Moldova	3.0	2.0	2.5
Romania	2.7	2.0	2.4
Uzbekistan	2.7	2.0	2.4
Ukraine	2.3	2.0	2.2
Albania	2.0	2.0	2.0
Azerbaijan	2.0	2.0	2.0
Tajikistan	2.0	1.7	1.9
Turkmenistan	1.7	1.7	1.7
Bosnia-Herzegovina	1.0	1.7	1.4
Belarus	1.0	1.0	1.0
CEE & NIS	3.0	2.2	2.6
Northern Tier CEE	3.5	3.0	3.3
Southern Tier CEE	2.6	2.1	2.4
NIS	2.9	2.0	2.4
Industrial Countries	5.0	5.0	5.0
Benchmarks	4.0	3.0	3.5

Note: On a 1 to 5 scale, with 5 being most advanced.
Source: EBRD, *Transition Report 1998* (November 1998, forthcoming).

Table 3. Third Round Economic Policy Reforms

Country	Competition Policy	Bank Reforms	Non-Bank Fin. Reforms	Legal Reforms		Environmental Policy	Average
Hungary	3.0	4.0	3.3	4.0	(4/4)	4.5	3.8
Poland	3.0	3.3	3.3	4.0	(4/4)	4.5	3.6
Czech Republic	3.0	3.0	3.0	4.0	(4/4)	4.5	3.5
Estonia	2.7	3.3	3.0	3.0	(3/4)	3.5	3.1
Slovakia	3.0	2.7	2.3	2.0	(3/2)	4.0	2.8
Romania	2.0	2.3	2.0	4.0	(4/4)	3.5	2.8
Lithuania	2.3	3.0	2.3	3.0	(4/3)	3.0	2.7
Latvia	2.7	2.7	2.3	2.3	(3+/2)	3.5	2.7
Slovenia	2.0	3.0	3.0	3.0	(3/3)	2.5	2.7
Bulgaria	2.0	2.7	2.0	4.0	(4/4)	2.5	2.6
Croatia	2.0	2.7	2.3	3.0	(4/3)	3.0	2.6
Russia	2.3	2.0	1.7	3.0	(4-/2)	3.5	2.5
Moldova	2.0	2.3	2.0	3.0	(4/3)	3.0	2.5
Armenia	2.0	2.3	2.0	3.0	(4/3)	2.0	2.3
Ukraine	2.0	2.0	2.0	2.0	(2/2)	3.0	2.2
Georgia	2.0	2.3	1.0	3.0	(3/3)	2.5	2.2
Kyrgyzstan	2.0	2.7	2.0	2.0	(3/2)	2.0	2.1
Albania	2.0	2.0	1.7	2.0	(2/2)	2.5	2.0
FYR Macedonia	1.0	3.0	1.0	3.0	(3/4)	2.0	2.0
Belarus	2.0	1.0	2.3	2.0	(2/2)	2.5	2.0
Kazakhstan	2.0	2.3	2.0	2.0	(2+/2)	1.5	2.0
Uzbekistan	2.0	1.7	2.0	2.0	(2+/2)	1.5	1.8
Azerbaijan	1.0	2.0	1.7	2.0	(3/2)	2.0	1.7
Bosnia-Herzegovina	1.0	2.0	1.0	1.0	(2/1)	2.3	1.5
Tajikistan	1.0	1.0	1.0	2.0	(2/3)	1.5	1.3
Turkmenistan	1.0	1.0	1.0	...	(na/na)	2.0	1.3
CEE & NIS	2.2	2.2	2.0	2.9		3.2	2.5
Northern Tier CEE	2.9	3.3	3.1	3.7		4.3	3.5
Southern Tier CEE	1.9	2.4	1.9	3.5		3.0	2.5
NIS	2.1	1.9	1.8	2.6		2.9	2.3
Industrial Countries	5.0	5.0	5.0	5.0		5.0	5.0
Benchmarks	4.0	3.0	4.0	4.0		4.0	3.8

Note: On a 1 to 5 scale, with 5 being most advanced. Ratings of legal reforms to foster investment are subdivided (in parentheses) into extensiveness and effectiveness.

Source: EBRD, *Transition Report 1998* (November 1998, forthcoming); environmental policy ratings are drawn from EBRD (November 1997) and are calculated in *Monitoring Country Progress* (January 1998).

Table 4. Change in Economic Policy Reforms: 1994-1998

	1st Round			2nd Round		3rd Round				
	1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**Average**
Georgia	2.0	0.0	3.0	2.3	1.0	1.0	1.3	0.0	1.0 (+)	1.3
Azerbaijan	2.0	0.0	2.0 (+)	1.0	1.0	0.0	1.0	0.7 (+)	2.0 (+)	1.1
Armenia	0.0	0.0	2.0	2.0	1.0	1.0	1.3	1.0 (+)	1.0	1.0
Kazakhstan	2.0 (+)	0.0	2.0	1.0	1.0	0.0	1.3	0.0	0.0	0.8
Ukraine	1.3	0.0	1.7 (–)	1.0	1.0	0.0	1.0	0.0	1.0	0.8
Moldova	1.3 (+)	0.0	2.0	1.0	0.0	0.0	0.3 (+)	0.0	2.0 (+)	0.7
Latvia	1.0	0.0	0.0	1.0	1.0	0.7	-0.3 (–)	0.3	1.3 (–)	0.6
Bulgaria	1.0	0.0	0.0	1.0	0.3	0.0	0.7	0.0	2.0 (+)	0.6
Romania	0.3 (+)	0.0	0.0	1.0	0.0	1.0	0.6 (–)	0.0	2.0 (+)	0.6
Hungary	1.0	0.3	1.0	1.0	0.3 (+)	0.0	1.0	0.3	0.0	0.5
Albania	1.0	0.0	0.0	1.0	0.0	1.0	0.0	0.7	1.0	0.5
FYR Macedonia	0.0	0.0	0.0	1.0	0.0	0.0	1.0	0.0	2.0 (+)	0.4
Tajikistan	0.3 (+)	0.3 (+)	1.7 (+)	0.0	0.7 (+)	0.0	0.0	0.0	...	0.4
Croatia	1.0	0.0	0.0	0.0	1.0	1.0	0.0	0.3	0.0 (–)	0.4
Estonia	1.0	0.0	0.0	1.0	0.0	0.0	0.3	1.0	0.0 (–)	0.4
Uzbekistan	0.0	-0.7 (–)	-0.3	1.0	1.0	0.0	1.0	0.0	1.0	0.3
Poland	1.0	0.3 (+)	1.0	0.3	0.0	0.0	0.3 (+)	0.3	0.0	0.3
Slovenia	1.0	0.0	1.0	1.0	0.0	0.0	0.0	0.0	0.0	0.3
Turkmenistan	1.0	0.0	0.0	0.7 (–)	0.7	0.0	0.0	0.0	...	0.3
Lithuania	0.0	0.0	0.0	0.0	1.0	0.3	1.0	0.3	0.0	0.3
Kyrgyzstan	0.0	0.0	1.0	0.0	0.0	0.0	0.7	0.0	0.0	0.2
Slovakia	1.0	0.0	1.0 (+)	1.0	0.0	0.0	0.0	-0.7	-1.0 (–)	0.1
Russia	1.0	-0.3 (–)	-0.7 (– –)	0.3	0.0	0.3	0.0 (–)	-0.3 (– –)	1.0	0.1
Czech Republic	1.0	0.0	0.0 (–)	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Belarus	0.0	-1.0 (–)	0.0	-1.0	-1.0	0.0	0.0	0.3 (+)	-1.0	-0.4
CEE & NIS	0.9	-0.1 (–)	0.3 (–)	0.6	0.3	0.2	0.4 (–)	-0.1 (–)	0.8 (+)	0.4
Northern Tier CEE	1.0	0.2 (+)	0.7 (–)	0.4	0.1	0.0	0.3 (+)	0.2	0.0 (–)	0.3
Southern Tier CEE	0.6 (+)	0.0	0.0	0.9	0.2	0.7	0.5 (–)	0.1	1.7 (+)	0.5
NIS	1.0	-0.2 (–)	0.3 (–)	0.6	0.4	0.2	0.4 (–)	-0.1 (–)	0.9 (+)	0.4
Benchmark										0 or greater

Note: The sub-headings refer to the following economic reforms: (1) small-scale privatization; (2) price liberalization; (3) trade and foreign exchange reforms; (4) large-scale privatization; (5) enterprise restructuring; (6) competition policy; (7) bank reforms; (8) non-bank financial reforms; and (9) legal reforms. The change is based on a rating from 1 to 5, e.g., a "1" represents a policy advancement by a full increment since the previous time period. For most of the indicators, the figures represent change (or absence of change) from 1994 to 1998; for price liberalization, competition policy, legal reforms, and non-bank financial reform indicators, from 1995 to 1998. A (+) represents an advancement from August 1997 to September 1998, a (–) represents a deterioration during that same period; (– –) represents a deterioration > 1.0.

Source: EBRD, *Transition Report 1998* (November 1998, forthcoming), and previous editions of the EBRD report.

Table 5. Economic Policy Reforms: Freedom House Ratings

Country	Privatization	Macro Policy	Micro Policy	Average	% Change 1997-1998
Hungary	1.50	1.75	1.75	1.7	0.0
Poland	2.25	1.75	1.75	1.9	0.0
Czech Republic	2.00	↓ 2.00	↓ 2.00	2.0	-6.5
Estonia	↑ 2.00	2.00	2.00	2.0	6.1
Slovenia	↑ 2.50	2.00	2.00	2.2	5.4
Latvia	2.50	2.50	2.50	2.5	0.0
Lithuania	2.25	2.75	2.75	2.6	0.0
Slovakia	3.25	↓ 3.75	↓ 3.75	3.6	-3.6
Kyrgyzstan	↓ 4.25	3.50	3.50	3.8	-3.3
Croatia	4.00	3.75	3.75	3.8	0.0
Russia	↓ 3.25	↓ 4.25	↓ 4.25	3.9	-6.9
Georgia	↑ 4.00	4.00	4.00	4.0	3.1
Armenia	↑ 3.75	↓ 4.25	↓ 4.25	4.1	0.0
Bulgaria	↑↑ 4.00	↑↑ 4.00	↑↑ 4.25	4.1	27.8
Moldova	4.00	↓ 4.25	↓ 4.25	4.2	-3.1
Albania	↓ 4.00	↓↓ 5.00	↓ 4.50	4.5	-9.0
Kazakhstan	4.25	4.50	↓ 4.75	4.5	-1.4
Romania	4.50	↑ 4.50	↑ 4.50	4.5	2.7
FYR Macedonia	4.00	5.00	5.00	4.7	0.0
Ukraine	↓ 4.50	↓ 4.50	↓↓ 5.25	4.8	-9.8
Yugoslavia	4.50	5.00	5.00	4.8	...
Azerbaijan	↑ 5.00	5.00	5.00	5.0	2.5
Tajikistan	6.25	6.00	↑ 5.75	6.0	1.0
Bosnia-Herzegovina	6.50	6.00	6.00	6.2	...
Belarus	6.00	↓ 6.25	↓↓ 6.50	6.3	-3.1
Uzbekistan	6.25	6.25	6.25	6.3	0.0
Turkmenistan	6.75	↓ 6.25	↓ 6.25	6.4	-1.9
Regions					
CEE & NIS	3.78	4.13	4.23	4.0	-3.4
Northern Tier CEE	2.19	2.02	2.02	2.1	-0.9
Southern Tier CEE	4.44	↑ 4.50	↑ 4.51	4.5	6.4
NIS	↓ 4.09	↓ 4.62	↓ 4.77	4.5	-5.5

Source: Freedom House, *Nations in Transit 1998* (October 1998).

Note: Data represent reforms as of April 1998. A "↑" represents an advancement from January 1997 to April 1998, a "↓" represents a deterioration. Single arrows represent a change greater than 0.1; double arrows, a change greater than 0.5.

Table 6. Economic Policy Reforms: EBRD & Freedom House Ratings Compared

	Freedom House (10/98)			EBRD (11/98)	
Country	Rating (1 to 5)	Ranking	Country	Rating (1 to 5)	Ranking
Hungary	4.6	1	Hungary	3.9	1
Poland	4.4	2	Poland	3.8	2
Czech Republic	4.3	3	Czech Republic	3.7	3
Estonia	4.3	3	Estonia	3.5	4
Slovenia	4.2	5	Slovakia	3.4	5
Latvia	4.0	6	Slovenia	3.3	6
Lithuania	3.9	7	Croatia	3.1	7
Slovakia	3.3	8	Lithuania	3.0	8
Kyrgyzstan	3.2	9	Latvia	3.0	8
Croatia	3.1	10	Romania	2.9	10
Russia	3.1	10	Bulgaria	2.9	10
Georgia	3.0	12	Moldova	2.8	12
Armenia	2.9	13	Georgia	2.7	13
Bulgaria	2.9	13	Russia	2.7	13
Moldova	2.9	13	Kyrgyzstan	2.7	13
Albania	2.7	16	Armenia	2.6	16
Kazakhstan	2.7	16	FYR Macedonia	2.6	16
Romania	2.7	16	Kazakhstan	2.6	16
FYR Macedonia	2.6	19	Albania	2.5	19
Ukraine	2.5	20	Ukraine	2.4	20
Yugoslavia	2.4	21	Azerbaijan	2.2	21
Azerbaijan	2.3	22	Uzbekistan	2.1	22
Tajikistan	1.7	23	Tajikistan	1.8	23
Bosnia-Herzegovina	1.6	24	Belarus	1.7	24
Belarus	1.5	25	Bosnia-Herzegovina	1.6	25
Uzbekistan	1.5	25	Turkmenistan	1.5	26
Turkmenistan	1.4	27			
CEE & NIS	3.0		CEE & NIS	2.7	
Northern Tier CEE	4.3		Northern Tier CEE	3.7	
Southern Tier CEE	2.8		Southern Tier CEE	2.8	
NIS	2.7		NIS	2.5	
EU				5.0	

Note: On a 1 to 5 scale, with 5 representing most advanced. Data for Yugoslavia are not available from EBRD.

Source: EBRD, *Transition Report 1998* (November 1998, forthcoming); Freedom House, *Nations in Transit 1998* (October 1998, forthcoming).

B. Democratization

Progress towards democracy building is assessed from indicators drawn from Freedom House. First, the status and the change since 1991 in political rights and civil liberties are examined. Second, 1997-1998 democratic trends are further disaggregated and reviewed. As with the economic reforms, sufficient progress must entail both an adequate threshold as well as no significant deterioration.

Political Rights and Civil Liberties. Six primary criteria go into the determination of ***political freedoms***: (1) the extent to which elections for head of government are free and fair; (2) the extent to which elections for legislative representatives are free and fair; (3) the ability of voters to endow their freely elected representatives with real power; (4) the openness of the system to competing political parties; (5) the freedom of citizens from domination by the military, foreign powers, totalitarian parties, and other powerful groups; and (6) the extent to which minority groups have reasonable self-determination and self-government.

Greater political liberties are both part of the end objective of a sustainable transition as well as a means to facilitate the economic reforms needed to achieve the transition. Arguably, the most credible route must be one which is facilitated by an open and competitive political system at all levels of government. This system must be sustained by broad-based participation from the electorate, and this electorate must have genuine influence on the course of political events. Such a route may not be the most rapid means of change, but it is by definition the most agreeable means among the citizens and hence likely the most sustainable.

Ten primary criteria go into the determination of ***civil liberties***: (1) freedom of media, literature, and other cultural expressions; (2) existence of open public discussion and free private discussion including religious expressions; (3) freedom of assembly and demonstration; (4) freedom of political or quasi-political organization (which includes political parties, civic associations, and ad hoc issue groups); (5) equality of citizens under law with access to independent, nondiscriminatory judiciary; (6) protection from political terror and freedom from war or insurgency situations; (7) existence of free trade unions, professional organizations, businesses or cooperatives, and religious institutions; (8) existence of personal social freedoms, which include gender equality, property rights, freedom of movement, choice of residence, and choice of marriage and size of family; (9) equality of opportunity; and (10) freedom from extreme government indifference and corruption.

Civil liberties are the freedoms to develop views, institutions, and personal autonomy apart from the state. The development of civil liberties, like political liberties, is an end objective in itself. The merits of such liberties as freedom of assembly and open public discussions, and freedom from political terror and war are self-evident.

However, greater civil liberties can also serve as a crucial counterweight or check on governments in societies where political rights are lacking. This counterweight can be found among NGOs (such as free trade unions, professional organizations, and religious institutions) as well as a free media. An independent, nondiscriminatory judiciary is critical for similar reasons.

In addition, civil liberties tend to link quite closely with economic progress. Many--such as greater equality of opportunity, freedom from corruption, the existence of personal social freedoms such as gender equality, property rights, freedom of movement--contribute to a more productive economy as well as a more just one.

Table 7 below highlights Freedom House's assessments of political rights and civil liberties from 1991 through 1997. The range in progress in democratization across the countries is great. At one extreme, there now exist seven transition countries--the Czech Republic, Estonia, Hungary, Lithuania, Poland, Slovenia, and most recently, Latvia--where political rights and civil liberties are roughly comparable to those found in Western Europe (such as in France, Germany, Italy, and the UK). Three of these countries--the Czech Republic, Hungary, and Slovenia--have maintained this level of freedom since at least 1993. Poland and Lithuania achieved this level in 1995, Estonia in 1996, and Latvia in 1997. Of these seven countries, only Latvia and Estonia experienced a temporary relapse in democratic freedoms since 1991.

In contrast, Turkmenistan is among a handful of countries worldwide rated by Freedom House to have the fewest political rights and civil liberties in 1997; one of sixteen countries out of 191 countries to receive the poorest score. Democratic freedoms in Uzbekistan, Tajikistan, and Belarus are not much greater than those in Turkmenistan.

Overall, the NIS lag considerably behind the CEE and the Northern Tier CEE in particular in both political rights and civil liberties. Moreover, the gap in freedoms between the subregions is not closing. Since 1991, in fact, eight of the twelve NIS have experienced a decrease in democratic freedoms; only Georgia, Moldova, and Armenia have witnessed an overall increase.

Democratization Disaggregated. In its *Nations in Transit 1998*, Freedom House further disaggregates democratization trends in the region. *Table 8* displays this effort. Six components of democracy building are rated on a one-to-seven scale in each country. The ratings represent events as of early April 1998 and are compared with progress at the end of 1996.

The ***political process*** focuses on elections, party configuration, political competition, and popular participation in elections. ***Civil society*** assesses the status of nongovernmental organizations; the number and nature of NGOs, and the degree of participation. ***Independent media*** attempts to measure freedom from government control (such as legal protection, editorial independence, and the extent of privatization) and the financial viability of private media. ***Governance and Public Administration*** focuses on legislative and executive effectiveness, and on government decentralization, including the independence and effectiveness of local and regional government. ***Rule of law*** examines constitutional reforms, the development and independence of the judiciary, and the rights of ethnic minorities. Finally, the scope of ***corruption*** (official corruption in civil service; public-private sector links; anti-corruption laws and decrees adopted and enforced) is also assessed.

The results of Freedom House's attempts to quantify these six components of democratic freedoms are not directly comparable with the more aggregate ratings of political rights and civil liberties by Freedom House. In fact, the disaggregated components are likely better tailored to the particulars of the transition region than is the more aggregate measures which are applied worldwide.

Still, broad trends coincide; the country rankings, in particular, are very similar between the two schemes. Two differences are notable, however. One, the more disaggregated (and more sophisticated) scheme of *Table 8* shows greater differentiation between the Northern Tier CEE leaders in progress towards democratization. Two, the gap between the Northern Tier leaders and the rest (including Slovakia) is greater in the more disaggregated scheme. Both trends are partially explained by the inclusion (for the first time this year) of a measure of corruption in the disaggregated scheme.

From early 1997 to April 1998, ten countries witnessed a decrease in democratic freedoms, while only six experienced an increase. This reverses a more favorable trend in 1996 (when nine countries had an increase in freedoms and five a decrease). None of the backsliding occurred in the transition leaders. In fact, Lithuania made gains in four areas, and Slovenia, Estonia, and Poland each in one area. Broad-based gains also occurred in Bulgaria, Tajikistan, Georgia (though backsliding also occurred in public administration), and Slovakia. Broad-based losses occurred in Albania and several NIS: Russia, Ukraine, and Belarus, in particular. Only three countries--Kazakhstan, Moldova, and Georgia--experienced mixed results; that is, gains in one or more areas alongside losses in others.

In general, the gap in democratic freedoms between CEE and the NIS increased during 1997 to early 1998. For the transition region as a whole, democratic freedoms are most advanced in political processes and civil society, and least advanced in the fight against corruption.

Table 7. Political Rights and Civil Liberties[1]

	1991		1994		1997		1994-97 Change[2]		1991-97 Change[3]	
	PR	CL	PR	CL	PR	CL	PR	CL	PR	CL
Czech Republic	...	...	1	2	1	2	0	0	...	...
Estonia	2	3	3	2	1	2	+ 2	0	+ 1	+ 1
Hungary	2	2	1	2	1	2	0	0	+ 1	0
Latvia	2	2	3	2	1	2	+ 2	0	+ 1	0
Lithuania	2	3	1	3	1	2	0	+ 1	+ 1	+ 1
Poland	2	2	2	2	1	2	+ 1	0	+ 1	0
Slovenia	...	...	1	2	1	2	0	0	0	0
Romania	5	5	4	3	2	2	+ 2	+ 1	+ 3	+ 3
Bulgaria	2	3	2	2	2	3	0	− 1	0	0
Slovakia	...	...	2	3	2	4	0	− 1	...	...
FYR Macedonia	...	...	4	3	4	3	0	0	− 1	0
Georgia	6	5	5	5	3	4	+ 2	+ 1	+ 3	+ 1
Moldova	5	4	4	4	3	4	+ 1	0	+ 2	0
Russia	3	3	3	4	3	4	0	0	0	− 1
Ukraine	3	3	3	4	3	4	0	0	0	− 1
Albania	4	4	3	4	4	4	− 1	0	0	0
Croatia	...	...	4	4	4	4	0	0	0	0
Kyrgyzstan	3	4	4	3	4	4	0	− 1	− 1	0
Armenia	5	5	3	4	5	4	− 2	0	0	+ 1
Azerbaijan	5	5	6	6	6	4	0	+ 2	− 1	+ 1
Kazakhstan	5	4	6	5	6	5	0	0	− 1	− 1
Belarus	4	4	4	4	6	6	− 2	− 2	− 2	− 2
Tajikistan	5	5	7	7	6	6	+ 1	+ 1	− 1	− 1
Uzbekistan	6	5	7	7	7	6	0	+ 1	− 1	− 1
Turkmenistan	6	5	7	7	7	7	0	0	− 1	− 2

Region	1991		1994		1997		1994-97 Change		1991-97 Change	
	PR	CL	PR	CL	PR	CL	PR	CL	PR	CL
CEE & NIS	3.5	3.4	3.4	3.9	3.2	3.8	+ 0.2	+ 0.1	+ 0.2	− 0.4
Northern Tier CEE	2.0	2.1	1.7	2.1	1.1	2.1	+ 0.6	0.0	+ 0.9	− 0.1
Southern Tier CEE	4.2	4.4	3.5	3.0	2.5	2.6	+ 1.0	+ 0.3	+ 1.7	+ 1.8
NIS	3.7	3.5	3.8	4.5	3.9	4.4	0.0	+ 0.1	− 0.2	− 0.9
European Union[4]					1.0	1.5				
OECD[5]					1.2	1.7				
Benchmarks					1.0	2.0	0.0	0.0		

Notes: [1]Ratings from 1 to 7, with 1 representing greatest development of political rights/civil liberties. [2]A "+" refers to an increase in freedoms. [3]The change for Croatia, FYR Macedonia, and Slovenia is calculated from 1992 to 1997. [4]All 15 EU members score "1" in Political Rights. In Civil Liberties 8 of the 15 members score a "1"; 6 score a "2" (Belgium, France, Germany, Italy, Spain and the UK); and Greece scores a "3". [5]All but three OECD members score a "1" in Political Rights; the exceptions are Turkey ("4"), Mexico ("3"), and Korea ("2"). For Civil Liberties, 15 members score a "1"; 11 score a "2" (Belgium, Czech Republic, France, Germany, Hungary, Italy, Japan, Korea, Poland, Spain, and the UK); Greece scores a "3"; Mexico scores a "4"; Turkey scores a "5".

Source: Freedom House, *Freedom in the World: 1997-1998* (May 1998).

Table 8. Democratization Disaggregated

Country	Political Process	Civil Society	Independent Media	Govt/Public Administration	Rule of Law	Corruption	Average	% Change Since 1996
Poland	1.3 ⇧	1.3	1.5	1.8	1.5	1.0	1.4	0%
Hungary	1.3	1.3	1.5	1.8	1.8	1.0	1.5	0%
Slovenia	2.0	2.0	1.8	2.5	1.5 ⇧	1.0	1.8	0%
Czech Republic	1.3	1.5	1.3	2.0	1.5	3.0	1.8	0%
Lithuania	1.8 ⇧	2.0 ⇧	1.5 ⇧	2.5	2.0 ⇧	3.0	2.1	9%
Estonia	1.8 ⇧	2.3	1.8	2.3	2.3	3.0	2.3	0%
Latvia	2.0	2.3	1.8	2.5	2.3	3.0	2.3	0%
Bulgaria	2.8 ⇧	3.8 ⇧	3.5 ⇧	4.0 ⇧	3.8 ⇧	5.0	3.8	8%
Slovakia	3.5 ⇧	3.0 ⇧	4.0 ⇧	3.8	4.0	5.0	3.9	3%
FYR Macedonia	3.5	3.8	4.0	4.0	4.5 ⇩	5.0	4.1	-3%
Romania	3.3	3.8	4.0 ⇧	4.0 ⇧	4.3	5.0	4.1	3%
Moldova	3.5 ⇩	3.8	4.3 ⇩	4.5 ⇩	4.0 ⇧	5.0	4.2	-3%
Croatia	4.3 ⇩	3.5	4.8	4.0	4.8	5.0	4.4	-2%
Russia	3.5	4.0 ⇩	4.3 ⇩	4.5 ⇩	4.3 ⇩	7.0	4.6	-8%
Georgia	4.5 ⇧	4.3 ⇧	4.3 ⇧	5.0 ⇩	4.8 ⇧	5.0	4.7	2%
Ukraine	3.5 ⇩	4.3 ⇩	4.8 ⇩	4.8 ⇩	4.0 ⇩	7.0	4.7	-8%
Kyrgyzstan	5.0	4.5	5.0	4.5 ⇩	4.5	7.0	5.1	0%
Albania	4.5 ⇩	4.3	4.8	5.0 ⇩	5.3 ⇩	7.0	5.2	-4%
Armenia	5.8 ⇩	3.5	5.3	4.5	5.0 ⇩	7.0	5.2	-2%
Yugoslavia	5.0	5.0	4.5	5.0	5.0	7.0	5.3	...
Kazakhstan	5.5	5.0 ⇧	5.5 ⇩	5.5	5.3 ⇩	7.0	5.6	-2%
Azerbaijan	5.5 ⇧	5.0	5.5	6.3	5.5	7.0	5.8	0%
Belarus	6.3 ⇩	5.8 ⇩	6.5 ⇩	6.3 ⇩	6.3 ⇩	5.0	6.0	-5%
Bosnia-Herzegovina	6.0	6.0	6.3	6.5	6.5	5.0	6.1	...
Tajikistan	5.8 ⇧	5.3 ⇧	6.0 ⇧	6.8 ⇧	6.0 ⇧	7.0	6.2	3%
Uzbekistan	6.5 ⇩	6.5	6.5	6.3 ⇩	6.5	7.0	6.6	-2%
Turkmenistan	7.0	7.0	7.0	6.8	6.8	7.0	6.9	0%

	Political Process	Civil Society	Independent Media	Govt/Public Administration	Rule of Law	Corruption	Average	% Change Since 1996
CEE & NIS	3.6	3.9 ⇩	4.2 ⇩	4.3 ⇩	4.1 ⇩	5.7	4.3	-4%
Northern Tier CEE	1.5 ⇧	1.6	1.7	2.1	1.8	1.8	1.7	1%
Southern Tier CEE	3.4 ⇧	3.8	4.1 ⇧	4.1 ⇧	4.3 ⇧	5.2	4.2	3%
NIS	4.2 ⇩	4.5 ⇩	4.9 ⇩	5.0 ⇩	4.7 ⇩	6.9	5.0	-6%

Note: On a scale from 1 to 7, with 1 representing most free. A "⇧" indicates an increase in democratization since 1996; a "⇩" signifies a decrease. Data cover from 1997 through April 1, 1998. A positive percentage change denotes an improvement since 1996. Change calculation does not include corruption component, as data on corruption were not previously available from Freedom House. Ratings for Bosnia-Herzegovina and Yugoslavia are provided for the first time in this issue of *Nations in Transit* .

Source: Freedom House, *Nations in Transit 1998* (October 1998).

C. Summary of Economic Reforms & Democratization

Table 9 provides a summary picture of the status of the economic policy reforms and democratic freedoms. The economic policy reform ratings represent an average of all ten EBRD policy indicators (that is, all three rounds). The democratic freedom ratings average Freedom House's six democratization components (from *Table 8*). For uniformity, Freedom House's ratings have been compressed to a one-to-five scale with five representing the most free. The *Summary Figure* portrays these data in part to help ascertain how and to what extent economic policy and democratic reforms might be linked.

The *Summary Figure* suggests three country groups differentiated by progress towards economic and democratic reforms. The most clearly defined group consists of the Northern Tier CEE countries (less Slovakia). These countries are substantially out front, particularly in democratic reforms. At the other end of the reform spectrum are the laggards: three Central Asian Republics (Turkmenistan, Tajikistan, and Uzbekistan), Belarus, possibly Azerbaijan, and one CEE country recovering from war (Bosnia-Herzegovina). The middle group is the largest and includes the Southern Tier CEE countries, Russia, Ukraine, and other NIS.

The spread in progress between the three groups is more evident in democratization than it is in economic reforms. Seven of the Northern Tier countries now have democratic standards roughly comparable to many Western democracies. Turkmenistan ranks among the least democratic worldwide, and freedoms in Uzbekistan are not much greater. Linked to this trend is the observation that economic policy reforms in the region, relative to the standards in the industrial market economies, have far to go, even in the Northern Tier countries, notable recent progress in Poland and Hungary notwithstanding.

How does this picture compare with that of one year ago (as shown in *Monitoring Country Progress*, September 1997)? Three broad observations surface. One, the gap between the Northern Tier countries (less Slovakia) and the rest is more pronounced today; the Northern Tier countries look to be "pulling away." Nevertheless, the more recent picture also shows greater differentiation in progress within the Northern Tier CEE countries. Three, there looks to be an even closer correspondence today between economic and democratic reforms. Progress in both reform areas tend to go hand-in-hand, and more so now than in the past. Slovakia remains, however, the most notable exception to this trend having advanced relatively more in economic reforms than in democracy.

Two explanations underlie the evolving picture over the course of a year. One, most of the recent backsliding has occurred in the NIS, while the Northern Tier CEE and Southern Tier CEE on balance have moved forward. The second explanation stems from an improvement in methodology. This edition has incorporated Freedom House's more sophisticated measure of democratization. This is the average of the six democratization components (from *Table 8*), in lieu of the average of the more generic, more aggregated civil liberties and political rights indexes. Among the six components that go into measuring democratization is a new one: corruption. Adding this dimension directly contributes to an explanation of the three aforementioned observations.

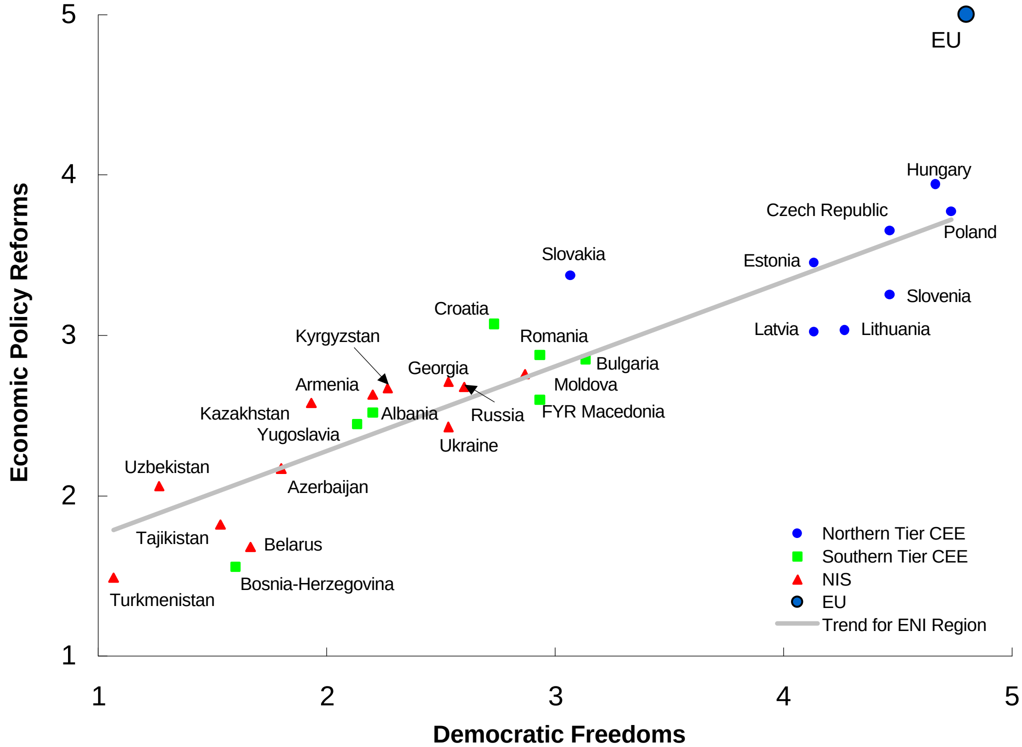
Table 9. Economic Policy Reforms and Democratic Freedoms in Central & Eastern Europe and the New Independent States: 1998

Economic Policy			Democratic Freedoms		
Country	**Rating (1 to 5)**	**Ranking**	**Country**	**Rating (1 to 5)**	**Ranking**
Hungary	3.9	1	Poland	4.7	1
Poland	3.8	2	Hungary	4.7	1
Czech Republic	3.7	3	Czech Republic	4.5	3
Estonia	3.5	4	Slovenia	4.5	3
Slovakia	3.4	5	Lithuania	4.3	5
Slovenia	3.3	6	Estonia	4.1	6
Croatia	3.1	7	Latvia	4.1	6
Lithuania	3.0	8	Bulgaria	3.1	8
Latvia	3.0	8	Slovakia	3.1	8
Romania	2.9	10	Romania	2.9	10
Bulgaria	2.9	10	FYR Macedonia	2.9	10
Moldova	2.8	12	Moldova	2.9	10
Georgia	2.7	13	Croatia	2.7	13
Russia	2.7	13	Russia	2.6	14
Kyrgyzstan	2.7	13	Georgia	2.5	15
Armenia	2.6	16	Ukraine	2.5	15
FYR Macedonia	2.6	16	Kyrgyzstan	2.3	17
Kazakhstan	2.6	16	Albania	2.2	18
Albania	2.5	19	Armenia	2.2	18
Yugoslavia	2.4	20	Yugoslavia	2.1	20
Ukraine	2.4	20	Kazakhstan	1.9	21
Azerbaijan	2.2	22	Azerbaijan	1.8	22
Uzbekistan	2.1	23	Belarus	1.7	23
Tajikistan	1.8	24	Bosnia-Herzegovina	1.6	24
Belarus	1.7	25	Tajikistan	1.5	25
Bosnia-Herzegovina	1.6	26	Uzbekistan	1.3	26
Turkmenistan	1.5	27	Turkmenistan	1.1	27

	Economic Policy Rating (1 to 5)	Democratic Freedoms Rating (1 to 5)
CEE & NIS	2.7	2.8
Northern Tier CEE	3.7	4.5
Southern Tier CEE	2.7	2.9
NIS	2.5	2.3
European Union	5.0	4.8
OECD	--	4.6

Ratings of democratic freedoms are from Freedom House, Nations in Transit 1998 (October 1998, forthcoming), and assess reforms to April 1, 1998. With 1 exception, economic policy reform ratings are from EBRD, Transition Report 1998 (November 1998, forthcoming), and cover events through early September 1998; economic policy reform rating for Yugoslavia is from Freedom House (October 1998). Ratings are based on a 1 to 5 scale, with 5 representing most advanced.

Summary Figure. Economic Policy Reforms and Democratic Freedoms in Central & Eastern Europe and the New Independent States: 1998



Ratings of democratic freedoms are from Freedom House, Nations in Transit 1998 (October 1998, forthcoming), and assess reforms to April 1, 1998. With 1 exception, economic policy reform ratings are from EBRD, Transition Report 1998 (November 1998, forthcoming), and cover events through early September 1998; economic policy reform rating for Yugoslavia is from Freedom House (October 1998). Ratings are based on a 1 to 5 scale, with 5 representing most advanced.

D. Sustainability

In this section, we weigh the economic and democratic reforms with the macroeconomic and microeconomic evidence. Economic policy reforms need to translate into good macroeconomic performance. Yet, this is not enough. The benefits at the macro level must also be reasonably well distributed and need to translate into social conditions that at the least are not significantly deteriorating. Otherwise, the reforms may stall for lack of support, and/or fiscal sustainability may be jeopardized.

It merits stating that the quality of these data is often questionable. Credible comparisons across time and across countries are sometimes difficult. In general, data for CEE are better than that for the NIS, and much of the economic data are likely better than much of the social data. Conclusions should be based on a variety of evidence if possible.

1. Macroeconomic Performance.

Tables 10 through *16* highlight macroeconomic performance. Fundamental to sustaining reforms is sustained **economic growth** at some moderate rate or greater. As evident in *Table 10*, the Northern Tier countries are achieving this. This sub-region overall in fact has been growing at a very impressive clip; more than five percent on average from 1995-1997. This is more than double the EU rate. The best performers among this group are Poland, Slovakia, and Estonia; the worst performer in 1997--at one percent growth--was the Czech Republic having gone through a currency crisis in the spring 1997. Economic growth in 1998 in the Northern Tier has slowed some, though is still likely to exceed an impressive four percent rate overall. Lower growth in the Baltics (Estonia, Latvia, and Lithuania) is likely attributed in part to crisis in Russia. All three countries continue to have significant trade links to Russia (with exports to Russia accounting for roughly twenty percent of total exports). Further, Latvia's banking sector is heavily exposed to Russian assets. In general, however, it is important to underscore that the Northern Tier countries have so far fared quite well from the global financial crisis. This reflects a solid foundation of reforms, and substantial and growing ties to Western Europe.

For the Southern Tier CEE, strong growth in 1994-1996 gave way to a sharp contraction overall in 1997. Albania, Bulgaria, and Romania all experienced substantial economic contractions in 1997 (close to seven percent in each case). These trends come in the wake of financial crises in Albania and Bulgaria, and a macroeconomic austerity package in Romania. The economies of Albania and Bulgaria have rebounded; ten percent growth is expected for Albania in 1998, and four percent for Bulgaria. In Bulgaria's case in particular, this return to growth reflects significant reform progress to stabilize the economy and to restructure the financial system. Romania's economy, in contrast, continues to languish in the context of continued political stalemate; the economy may contract by five percent in 1998.

1997 represented the first year of economic growth for the NIS on average since the transition began. This was largely because Russia's economy registered its first expansion in 1997 since communism's collapse; albeit at a very modest 0.8 percent. However, with the collapse of the Russian economy and its spillover to the region, overall expansion will not be repeated in 1998.

Preliminary estimates have Russia's economy contracting in 1998 anywhere from four to six percent. Moldova's economy will shrink and possibly also Ukraine's economy. Economic growth will be slower than earlier predicted in other NIS, particularly those with strong trade links to Russia, such as Kazakhstan and Belarus. The dramatic fall of prices of commodities, such as oil and metal, are also contributing to slower export growth and with it overall economic growth in several resource rich NIS.

Still, the majority of the NIS seem likely to experience growing economies in 1998, following a comparable pattern in 1996 and 1997. Of these, however, perhaps only three countries—Georgia, Armenia, and to a lesser degree, Kyrgyzstan—are experiencing robust, sustained (three years or more) growth. In general, economic growth remains precarious in the NIS at best, dependent on the weather (for those countries with key agricultural sectors such as Uzbekistan, Moldova, and Kyrgyzstan), and/or on commodity prices (such as Kazakhstan, Russia, Turkmenistan, and Azerbaijan in the case of oil), and much more vulnerable to external crises than is the case in CEE.

While **inflation** continues to fall for the majority of the transition economies, the overall average for the region has increased significantly in 1998, primarily due to Russia (*Table 11*). For the Northern Tier CEE countries, 1998 inflation may be ten percent; down from twelve percent in 1997 and sixteen percent in 1996. For the CEE overall, inflation rates in 1998 will likely be less than fifteen percent for all countries except Romania (where it will be closer to forty-five percent). The decrease in inflation from 1997 to 1998 in Albania and Bulgaria is particularly impressive. Albania's inflation in 1997 was over forty percent, and Bulgaria's was close to five hundred and eighty percent. Inflation is expected to fall to ten percent in 1998 in both countries. Still, it is important to note that these rates, even in the Northern Tier CEE, are high relative to EU standards where inflation in recent years has ranged from two to three percent. Only Croatia and Macedonia which have averaged roughly four percent inflation since 1996 come close to this norm. Beyond the importance of meeting the EU accession criteria, annual inflation rates much above the single-digit range erode business confidence, and the ability and incentive to invest and expand at the enterprise level.

In the NIS, progress in attaining and maintaining reasonable inflation rates is decidedly mixed. Seven NIS may have 1998 inflation rates less than fifteen percent. Moldova, Georgia, and Azerbaijan have been able to maintain these rates since 1996. The overall NIS average has increased dramatically in 1998, however, due primarily to inflation in Russia. A preliminary estimate by the EBRD has 1998 end-year inflation in Russia at one hundred and seventy percent. This is an increase from eleven percent in 1997; triggered by the August 17 devaluation and subsequent crisis. Russia's inflation may be much higher than this estimate, particularly if the government of Russia resorts to printing much money. Inflation is also likely to be significantly higher in 1998 than in 1997 in Ukraine, Belarus, and Turkmenistan, and somewhat higher in Uzbekistan.

Budget deficits (*Table 12*) that remain high fuel inflation and unproductive activity, particularly if financial markets are not well-functioning. If in fact the financial markets are well-established, high budget deficits may ultimately crowd out potential private sector investors from such markets. More generally, as witnessed in the case of Russia, persistently high budget deficits can seriously undermine investor confidence. With the recent development of securities markets, a number of countries have been able to finance deficits in a noninflationary manner at least in the short-term. But, such an approach is unsustainable if reducing the structural deficit is not tackled; all the more so if the share financed by foreign portfolio investors is significant.

While the fiscal balances overall for the transition region have improved substantially since the beginning of the transition, many countries still maintain unsustainably high deficits. Six countries had fiscal deficits equal to or greater than five percent of the GDP in 1997. This may increase to nine countries in 1998. Only three of these nine are CEE countries: Albania (with a deficit close to fourteen percent of GDP in 1998), Romania (5.5 percent), and Hungary (at five percent).

On the other hand, there may be as many as nine countries with 1995-1998 fiscal balances which equal or better the EU Maastricht target of a three percent deficit of GDP. Five of these are Northern Tier CEE countries. Poland (3.1 percent) and Lithuania (3.4 percent) are not far from this benchmark.

Table 13 shows trends in domestic investment and the share of the economies in private sector hands. The **private sector share of the economy** is a rough proxy for the extent of economic restructuring, either through the privatization process or the growth of new private-sector firms. Those economies which predominantly produce private sector output are much more likely to generate momentum towards greater economic expansion overall.

Nineteen countries of the region in fact now have a private sector generating at least fifty percent of GDP. The average for all of CEE and NIS is sixty-one percent. This represents very impressive gains; in 1989, the region's private sector share was probably closer to ten percent of GDP.

Most OECD economies have private sectors which range from seventy to eighty-five percent of GDP. Seven transition countries (five Northern Tier countries, Russia, and Albania) now have private sectors that meet this threshold. The private sector share of GDP is highest in Hungary (at eighty percent). Slovenia's private sector as a share of GDP is fifty-five percent. This is the lowest among the Northern Tier countries, though perhaps not much different from that of its neighbors, Austria and Italy. Six countries (all NIS) still have economies in which more than fifty percent of economic activity derives from the public sector. In Belarus, the public sector constitutes eighty percent of GDP.

Domestic investment (*Table 13*) contributes to the productive capacity of the economy and hence helps provide the momentum which is necessary for sustained economic expansion further down the road. Domestic investment in the region on average is roughly twenty-two percent of GDP. This is comparable to the average of the advanced industrialized economies, though it falls far short of investment rates that have been generated in the East Asian developing economies.

While domestic investment fell in the large majority of countries at the outset of the transition, it has fallen much more in the NIS. In fact, domestic investment as a percent of GDP was higher in the NIS in 1990 than in CEE, and lower by 1996. Domestic investment in the Northern Tier CEE has been increasing on average since at least 1994; from 1994-1996 it increased by almost forty percent. In contrast, domestic investment may still be declining in the Southern Tier CEE and in the NIS; from 1994-1996 it decreased by almost ten percent in the Southern Tier and closer to twenty percent in the NIS.

An important indicator of the extent to which firms are restructuring is the **productivity of labor**, or output per employee (*Table 14*). The efficiency gains from an increase in productivity would likely stem from a number of possibilities, including fewer excess workers, greater skilled and/or motivated workers, improved capital stock, and/or a greater capacity to manage.

Labor productivity growth in industry has been impressive in the Northern Tier CEE countries, but much less so most elsewhere for which data are available. It has been over ten percent annually on average in Hungary and Poland since 1992. Comparably high productivity growth has been occurring in the Czech Republic, Latvia, Croatia, and Lithuania since 1995 or 1996. At least six CEE countries (Hungary, Poland, Slovenia, the Czech Republic, Croatia, and Bulgaria) now have regained pre-transition levels of productivity. Productivity growth in Romania was equally impressive from 1993-1996, though slowed considerably in 1997 and declined sharply in the first quarter of 1998. Productivity growth has been stagnant (in 1996-1997) in Bulgaria as well.

Productivity growth in Russia has been relatively recent and modest. From 1995-1997, it grew by four percent. Labor productivity in industry in Russia in 1997 was only two-thirds the 1990 level.

How and to what extent these economies integrate into the world economy play significantly into the type of the transition path and its sustainability. *Tables 15 and 16* highlight some key aspects of this integration: export growth and openness to trade; current account balances; institutional integration; foreign direct investment; and external debt.

The gains from trade can be substantial, and range from the tangible (of increasing an economy's quantity and quality of available goods, including capital goods) to the intangible (of providing incentives and a constituency to maintain the market-based reforms which also serve as pre-requisites to institutional integration with the industrial market economies).

Export growth varies widely in the region. From 1995-1997, exports grew fastest in the Northern Tier CEE countries (at more than twenty percent), and slowest in the NIS (at ten percent). This compares to a seven percent export growth rate in the EU from 1995-1997. Export growth slowed considerably in 1997 to only three percent for the transition region overall. In fact, exports contracted in nine countries in 1997. All but two (Albania and Croatia) were NIS, and include Russia and Ukraine. Several countries have maintained very high export growth rates over the past several years: Hungary (close to forty percent); Lithuania (twenty-seven percent); and Bosnia-Herzegovina (eighty-six percent) in CEE; and Kyrgyzstan (twenty-five percent); and Belarus (forty-one percent) in the NIS.

Openness to trade or outward-orientation also varies widely throughout the region. This is a reflection in part of the fact that such an indicator is influenced by a handful of factors, including the competitiveness of the economy as well as its size (the smaller economies tend to be more outward-oriented out of necessity).

The Northern Tier CEE countries are the most outward-oriented; their exports and imports are close to forty percent of GDP. This is comparable to the average of the advanced economies, though falls significantly short of the EU average of sixty-one percent. The NIS are the least outward-oriented; with overall trade closer to twenty-percent of GDP. Three CEE countries meet the outward-oriented standard of the EU: Estonia (seventy-seven percent); Slovenia (seventy-four percent); and Croatia (sixty percent).

The merits of outward-orientation hinge in no small part on the direction and composition of trade.[4] The differences between the sub-regions in these matters are striking. By 1996, almost sixty percent of CEE exports went to the EU. In contrast, Russia sells thirty-three percent of its exports to Western Europe, and for the rest of the NIS, it is closer to only fifteen percent. Conversely, almost sixty percent of total exports from the NIS (less Russia) in 1996 stayed within the former Soviet Union. This is, nevertheless, down considerably from the proportion (close to ninety percent) in 1990. For CEE, less than fifteen percent of total exports are sold to the former Soviet Union; in 1990, it was thirty percent.

Export structures vary widely as well. In 1995, more than forty percent of CEE exports were manufactures. This compares to nine percent in the NIS. Forty-three percent of NIS exports in 1995 were raw materials and fuels; for CEE, these exports were less than fifteen percent of the total.

Most transition countries are incurring high **current account deficits** (*Table 15*). Twelve countries had a current account deficit equal to or greater than five percent of GDP on average from 1994-1996; this increased to eighteen countries in 1997 and 1998. Russia's current account in 1998 has swung significantly from deficit to surplus as a result of the August devaluation of the ruble. This has contributed to greater current account deficits elsewhere, particularly in the NIS. Moreover, the adverse impact on trade balances of the resource rich NIS from the reduced demand for exports from Russia is exacerbated by two further spillovers from the wider global economic crisis; namely, falling commodity prices and higher financing costs for imports.

To some extent, as the economies climb out of the transition trough and incur robust economic growth, current account deficits can be expected, and may even be a reflection of positive developments. In some of the CEE countries, in particular, current account deficits are leading to greater capital goods imports and to greater investments. This, in turn, presumably increases competitiveness and exports over the medium term.

---

[4] *Appendix II* highlights these trends.

Still, many current account deficits, particularly in the NIS, look to be unsustainable. This is especially the case when these deficits are combined with high fiscal deficits.[5] Current account deficits are highest in Armenia (close to thirty percent of GDP since 1994), Turkmenistan (thirty percent in 1997-1998), Azerbaijan (twenty-nine percent in 1997-1998), Moldova (fifteen percent in 1997-1998), Albania (twelve percent since 1994), Lithuania (thirteen percent in 1997-1998), and Estonia (twelve percent in 1997-1998).

An important means to institutionalizing global integration, and hence to locking-in the gains from reform, is through memberships and/or **participation in international organizations**. For our purposes, this includes membership or participation towards membership in the OECD, the World Trade Organization, NATO, and the European Union. As shown in *Table 15*, institutional integration, as so defined, is taking place almost exclusively among the CEE countries, and primarily in the Northern Tier. The Czech Republic, Hungary, and Poland have recently been invited to join NATO. In addition, these three countries plus Slovenia and Estonia have been invited to participate in the next round of negotiations towards EU membership. Kyrgyzstan and Latvia will soon be the most recent members in the region in the World Trade Organization. Of the eleven WTO members in the transition region, Kyrgyzstan is the first from the NIS.

Foreign direct investment (FDI) is key to the transition (*Table 16*). It helps meet the substantial fixed investment needs of the region that arise from obsolete fixed capital stocks and inadequate infrastructure. It does so without adding to the external debt burden. In the context of highly volatile short-term capital flows, it is a stabilizing influence. And, it brings with it some very important externalities, including access to advanced technology and export markets, and exposure to advanced management and marketing techniques. Moreover, FDI not only follows reforms, it also contributes towards catalyzing and sustaining more reforms.

FDI flows increased significantly in 1997 and look to be continuing at a comparable pace in 1998 (in contrast to trends of other capital flows). Perhaps roughly one-third of all FDI inflows since 1989 will have occurred in 1997 and 1998. Still, for many transition countries, the potential to attract such investment remains largely unrealized. The cumulative inflow during 1991-1996 may be close to four percent of the transition economies' GDP. This compares to six percent for Latin America and thirteen percent for the East Asian developing economies.

Most FDI continues to go to the advanced reformers and, to a lesser extent, resource rich countries. Close to one-half of the cumulative flows during 1991-1996, in fact, went to Hungary and the Czech Republic. On a per capita basis, Hungary has attracted far and away the greatest amount. However, there has been growing diversification in the destination of FDI flows to the region. FDI has recently increased significantly in Poland, Estonia, and Lithuania.

Much of the FDI in CEE has been tied to the privatization process, and most of it so far is inward-looking; that is, to produce or service for the domestic market. The relatively small amount of FDI that has flowed to the NIS has largely been in response to opportunities to exploit energy resources, in Turkmenistan, Azerbaijan, and Kazakhstan, in particular.

---

[5] See *Appendix II*.

The importance of a sustainable **external debt** position has increased in the current global economic context (*Table 16*). For most transition countries, the volume of external debt incurred remains manageable, and the overall level for the region has decreased since 1994. However, for many countries, external debt has been increasing recently. Moreover, the number of countries that, by World Bank standards, are "severely" and/or "moderately" indebted is also increasing.[6] In 1996, two countries were severely indebted and four were moderately indebted. By 1997, three countries were severely indebted (Albania, Armenia, and Georgia), and seven countries were moderately indebted (Bulgaria, Turkmenistan, Croatia, Kyrgyzstan, Moldova, Poland, and Russia). The high indebtedness among some in the NIS is striking given that Russia assumed all the Soviet debt at the outset of the transition. Nevertheless, servicing the debt has not yet been too onerous for most countries. Hungary has the highest debt service as a proportion of exports (forty-four percent in 1997), followed by Turkmenistan (thirty-five percent). All other countries had a debt service ratio below twenty percent in 1997. For the transition region as a whole, it was ten percent.

[6] The World Bank classifies a country as severely indebted if its debt-export ratio exceeds 220 percent, and moderately indebted if debts are more than 132 percent of exports.

Table 10. Growth in Real GDP (%)

Country	1992	1993	1994	1995	1996	1997	1998 est.	1995-1997 average
Bosnia-Herzegovina	…	…	…	33.0	28.0	15.0	20.0	**25.3**
Georgia	-44.8	-25.4	-11.4	2.4	10.5	11.0	8.0	**8.0**
Poland	2.6	3.8	5.2	7.0	6.1	6.9	5.2	**6.7**
Slovakia	-6.5	-3.7	4.9	6.9	6.6	6.5	4.8	**6.7**
Estonia	-14.2	-8.5	-1.8	4.3	4.0	11.4	5.0	**6.6**
Croatia	-11.7	-8.0	5.9	6.8	6.0	6.5	4.8	**6.4**
Armenia	-52.6	-14.8	5.4	6.9	5.8	3.1	6.0	**5.3**
Lithuania	-21.3	-16.2	-9.8	3.3	4.7	5.7	3.0	**4.6**
Czech Republic	-3.3	0.6	3.2	6.4	3.9	1.0	0.5	**3.8**
Albania	-7.2	9.6	9.4	8.9	9.1	-7.0	10.0	**3.7**
Slovenia	-5.5	2.8	5.3	4.1	3.1	3.3	4.0	**3.5**
Latvia	-34.9	-14.9	0.6	-0.8	3.3	6.5	4.0	**3.0**
Kyrgyzstan	-19.0	-16.0	-20.0	-5.4	7.1	6.5	4.0	**2.7**
Hungary	-3.1	-0.6	2.9	1.5	1.3	4.4	4.6	**2.4**
Romania	-8.7	1.5	3.9	7.1	4.1	-6.6	-4.5	**1.5**
Uzbekistan	-11.1	-2.3	-4.2	-0.9	1.6	2.4	2.0	**1.0**
Belarus	-9.6	-7.6	-12.6	-10.4	2.8	10.4	5.0	**0.9**
FYR Macedonia	-21.1	-9.1	-1.8	-1.2	0.8	1.5	5.0	**0.4**
Azerbaijan	-22.6	-23.1	-19.7	-11.8	1.3	5.8	7.0	**-1.6**
Kazakhstan	-2.9	-9.2	-12.6	-8.2	0.5	2.0	1.0	**-1.9**
Russia	-14.5	-8.7	-12.7	-4.1	-3.5	0.8	-5.0	**-2.3**
Moldova	-29.1	-1.2	-31.2	-3.0	-8.0	1.3	-2.0	**-3.2**
Tajikistan	-29.0	-11.0	-18.9	-12.5	-4.4	2.2	3.4	**-4.9**
Bulgaria	-7.3	-1.5	1.8	2.1	-10.9	-7.4	4.0	**-5.4**
Ukraine	-13.7	-14.2	-23.0	-12.2	-10.0	-3.2	0.0	**-8.5**
Turkmenistan	-5.3	-10.0	-18.8	-8.2	-8.0	-26.0	5.0	**-14.1**

Regional Averages	1992	1993	1994	1995	1996	1997	1998 est.	1995-1997 average
CEE & NIS	-12.0	-7.0	-9.2	-2.3	-1.0	1.2	-0.2	**-0.7**
Northern Tier CEE	-2.6	0.3	3.6	5.6	4.9	5.6	4.3	**5.4**
Southern Tier CEE	-9.2	-0.1	3.9	7.8	3.4	-3.4	1.4	**2.6**
NIS	-14.9	-10.0	-14.4	-5.9	-3.3	0.7	-1.6	**-2.8**
European Union	1.0	-0.5	2.9	2.4	1.7	2.7	2.9	**2.3**
Advanced Countries	1.9	1.2	3.2	2.5	3.0	3.1	2.0	**2.9**
Developing Countries	6.6	6.5	6.7	6.1	6.6	5.8	2.3	**6.2**

Benchmarks (a) 3 years positive economic growth, (b) 3 year average growth rate of 2% or more

Source: EBRD, *Transition Report 1998* (November 1998, forthcoming, and previous editions); IMF, *World Economic Outlook* (October 1998, forthcoming, and previous editions); *Economist Intelligence Unit* (most recent).

Table 11. Inflation

COUNTRY	1993	1994	1995	1996	1997	1998 (est.)	1996-97	1995-97
Croatia	1,149	-3	4	3	4	6	3.6	3.7
FYR Macedonia	230	55	9	-1	3	5	1.0	3.7
Slovakia	25	12	7	5	6	7	5.9	6.3
Czech Republic	18	10	8	9	10	10	9.3	8.8
Slovenia	23	20	9	9	9	7	8.9	8.9
Latvia	35	26	23	13	7	5	10.1	14.4
Moldova	837	116	24	15	11	12	13.2	16.7
Poland	38	29	22	19	13	10	15.9	17.8
Estonia	36	42	29	15	12	9	13.5	18.7
Lithuania	189	45	36	13	9	4	10.8	19.0
Armenia	10,896	1,885	32	6	22	7	13.8	19.8
Albania	31	16	6	17	42	10	29.8	21.8
Hungary	21	21	28	20	18	14	19.1	22.2
Georgia	7,488	6,474	57	14	7	9	10.8	26.3
Kyrgyzstan	1,363	96	32	35	15	12	24.9	27.2
Azerbaijan	1,294	1,788	85	7	0	4	3.5	30.5
Kazakhstan	2,169	1,160	60	29	11	9	20.0	33.4
Russia	840	204	129	22	11	170	16.4	53.8
Uzbekistan	885	1,281	117	64	28	32	46.0	69.7
Ukraine	10,155	401	182	40	10	22	24.9	77.3
Romania	296	62	28	57	151	45	104.2	78.7
Belarus	1,996	1,960	244	39	63	84	51.2	115.4
Bulgaria	64	122	33	311	579	10	444.7	307.4
Turkmenistan	9,750	1,328	1,262	446	22	33	233.8	576.5
Tajikistan	7,344	1	2,133	41	164	13	102.1	779.0

REGIONAL AVERAGES	1993	1994	1995	1996	1997	1998 (est.)	Average 1996-1997	Average 1995-1997
CEE & NIS	2,285	464	141	38	36	76	36.8	71.5
Northern Tier CEE	39	25	20	16	12	10	14.0	16.0
Southern Tier CEE	321	63	23	96	205	29	150.9	108.4
NIS	3,151	636	189	36	17	100	26.4	80.7
European Union	3.7	2.6	2.9	2.4	1.7	1.8	2.1	2.3
Advanced Countries	2.8	2.2	2.3	1.9	1.7	1.6	1.8	2.0
Developing Countries	47.2	51.6	22.3	14.1	9.1	10.3	11.6	15.2
Benchmarks							< 10.0	< 15.0

Note: Retail/consumer prices, end-year if available.

Source: EBRD, *Transition Report 1998* (November 1998, forthcoming), and earlier editions; IMF, *World Economic Outlook* (October 1998, forthcoming); *Economist Intelligence Unit* (most recent).

Table 12. Fiscal Balance as Percent of GDP

	1991	1992	1993	1994	1995	1996	1997	1998 estimate	1995-1997 average
Estonia	5.2	-0.3	-0.7	1.3	-1.3	-1.5	2.2	2.5	-0.2
Slovenia	2.6	0.2	0.3	-0.2	0.0	0.3	-1.1	-1.0	-0.3
Turkmenistan	2.5	13.2	-0.5	-1.4	-1.6	-0.2	0.0	-5.0	-0.6
FYR Macedonia	...	-9.6	-13.8	-2.9	-1.2	-0.5	-0.4	-0.8	-0.7
Croatia	-5.0	-3.9	-0.8	1.6	-0.9	-0.4	-1.3	-0.5	-0.9
Latvia	...	-0.8	0.6	-4.0	-3.3	-1.4	1.3	-2.3	-1.1
Slovakia	-2.0	-11.9	-7.0	-1.3	0.2	-1.9	-3.1	-2.7	-1.6
Czech Republic	-1.9	-3.1	0.5	-1.2	-1.8	-1.2	-2.1	-2.4	-1.7
Belarus	3.6	0.0	-1.9	-2.5	-1.9	-1.6	-2.1	-3.0	-1.9
Poland	-6.7	-6.7	-3.1	-3.1	-2.8	-3.3	-3.1	-3.1	-3.1
Kazakhstan	-7.9	-7.3	-1.4	-7.2	-2.5	-3.1	-3.7	-5.5	-3.1
Azerbaijan	-5.0	2.8	-15.3	-12.1	-4.9	-2.8	-1.7	-3.6	-3.1
Lithuania	2.7	0.5	-4.3	-5.3	-4.5	-3.9	-2.3	-3.0	-3.6
Romania	3.3	-4.6	-0.4	-1.9	-2.6	-3.9	-4.5	-5.5	-3.7
Georgia	-3.0	-25.4	-26.2	-7.4	-4.5	-4.4	-3.8	-2.5	-4.2
Uzbekistan	-3.6	-18.4	-10.4	-6.1	-4.1	-7.3	-2.3	3.0	-4.6
Hungary	-2.9	-6.8	-5.5	-8.4	-6.7	-3.5	-4.6	-4.9	-4.9
Ukraine	-13.6	-25.4	-16.2	-9.1	-7.1	-3.2	-5.6	-3.0	-5.3
Moldova	0.0	-26.2	-7.4	-8.7	-5.7	-6.7	-7.5	-7.5	-6.6
Tajikistan	-16.4	-28.4	-23.6	-10.2	-11.2	-5.8	-3.4	-3.3	-6.8
Russia	-31.0	-4.1	-4.2	-9.0	-5.7	-8.3	-7.4	-5.0	-7.1
Bulgaria	...	-5.2	-10.9	-5.8	-6.4	-13.4	-2.6	-1.6	-7.5
Armenia	-1.8	-13.9	-54.7	-10.5	-11.0	-9.3	-6.3	-5.8	-8.9
Albania	-31.0	-20.3	-14.4	-12.4	-10.3	-12.1	-12.7	-13.9	-11.7
Kyrgyzstan	4.6	-17.4	-14.2	-11.6	-17.0	-9.0	-9.4	-8.1	-11.8
REGIONAL AVERAGES	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998 estimate**	**1995-1997 average**
CEE & NIS	-15.3	-9.0	-7.0	-7.0	-5.0	-5.7	-5.1	-3.8	-5.3
Northern Tier CEE	-4.1	-5.7	-3.0	-3.4	-3.0	-2.8	-2.8	-3.0	-2.9
Southern Tier CEE	-1.7	-6.2	-4.4	-3.2	-3.7	-5.9	-4.2	-4.6	-4.6
NIS	-19.6	-10.2	-8.5	-8.5	-5.7	-6.4	-5.8	-3.9	-6.0
European Union	-4.3	-5.1	-6.4	-5.7	-5.2	-4.3	-2.3	-2.0	-3.9
Advanced Countries	-2.7	-3.6	-4.1	-3.4	-3.2	-2.5	-1.1	-1.2	-2.3
Developing Countries	-3.8	-3.4	-3.6	-3.3	-3.2	-2.9	-3.0	-3.5	-3.0
European Union Target									-3.0
Benchmark									-3.0

Note: General government balance for all countries.

Source: EBRD, *Transition Report* (November 1998, forthcoming); IMF, *World Economic Outlook* (October 1998, forthcoming).

Table 13. Domestic Investment and Private Sector Share of GDP

Country	Gross Domestic Investment 1990	1994 % of GDP	1996	1990-1996 % change	1994-1996 % change	Private Sector Output 1996 % of GDP	mid-year 1997
Hungary	25	22	27	8	23	70	80
Albania	29	14	21	-28	50	75	75
Czech Republic	29	20	35	21	75	75	75
Slovakia	34	17	38	12	124	70	75
Estonia	30	33	27	-10	-18	70	70
Lithuania	34	…	21	-38	…	65	70
Russia	30	27	22	-27	-19	60	70
Poland	26	16	20	-23	25	60	65
Armenia	47	10	10	-79	0	50	60
Kyrgyzstan	24	…	19	-21	…	50	60
Latvia	40	11	19	-53	73	60	60
Romania	30	27	25	-17	-7	60	60
Croatia	13	14	15	15	7	50	55
Georgia	…	…	4	…	…	50	55
Kazakhstan	43	24	23	-47	-4	40	55
Slovenia	17	21	23	35	10	45	55
Ukraine	28	…	23	-18	…	40	55
Bulgaria	26	21	14	-46	-33	45	50
FYR Macedonia	32	18	15	-53	-17	…	50
Azerbaijan	28	23	24	-14	4	25	45
Moldova	…	...	28	…	…	40	45
Uzbekistan	32	23	16	-50	-30	40	45
Tajikistan	23	…	17	-26	…	20	30
Turkmenistan	40	…	…	…	…	20	25
Belarus	27	…	25	-7	…	15	20
REGIONAL AVERAGES	**1990**	**1994 % of GDP**	**1996**	**1990-1996 % change**	**1994-1996 % change**	**1996 % of GDP**	**mid-year 1997**
CEE & NIS	30	24	22	-26	-7	52	61
Northern Tier CEE	28	18	25	-11	38	64	69
Southern Tier CEE	27	23	21	-24	-9	57	58
NIS	31	26	21	-30	-17	49	59
Advanced Economies			21			70-85	
Developing Countries			25				
Sub-Saharan Africa			18				
East Asia/Pacific			39				
Benchmarks		*GDI/GNP > 25%*			*no decline*	*more than 70%*	

Source: EBRD, *Transition Report 1998* (November 1998, forthcoming); World Bank, *World Development Indicators 1996/1997/1998* (June 1996/1997/1998).

Table 14. Labor Productivity

Region/Country	Labor Productivity in Industry/Manufacturing (% change) 1990	1991	1992	1993	1994	1995	1996	1997	1998 Q1	1995-97 average	1997/1989 (%)
CEE											
Latvia	...	...	...	...	9.5	-1.0	8.6	28.0	14.3	11.9	…
Hungary	0.4	-17.9	10.7	18.5	7.3	11.2	9.1	14.5	16.3	11.6	161
Romania	-24.6	-18.5	-12.3	9.0	10.1	20.0	12.1	1.0	-22.0	11.0	88
Czech Republic	-0.4	-16.6	-7.6	-3.5	4.9	11.1	9.6	11.1	15.0	10.6	105
Poland	-21.1	-11.9	17.1	14.5	13.9	7.0	9.9	13.9	15.1	10.3	142
Croatia	-10.0	-14.0	-1.0	-2.0	1.6	5.8	11.4	12.0	14.2	9.7	101
Lithuania	...	...	...	...	-12.1	12.0	8.5	4.6	15.1	8.4	…
Estonia	...	...	...	...	6.7	0.4	3.7	17.8	...	7.3	…
Slovenia	-9.0	-1.0	-1.0	5.0	11.4	7.2	6.6	5.2	9.8	6.3	125
Slovakia	...	...	7.4	0.6	6.8	4.0	2.5	4.8	6.5	3.8	…
Bulgaria	-10.4	-11.1	0.2	5.5	12.6	7.3	2.1	-3.8	...	1.9	100
NIS											
Russia	1.0	-5.0	-12.0	-14.2	-17.7	4.8	3.2	3.0	...	3.7	66
Ukraine	0.0	-5.0	-1.0	-1.0	-18.0	...	...	...	...	…	…

Source: EBRD, *Transition Report 1998* (November 1998, forthcoming), and previous editions of the EBRD report.

Table 15. Integration into the World Economy (I)

Country	Export Growth (average annual %) 1995-1997	Export Growth 1997	Openness to Trade (% of PPP GDP) 1996	Current Account Balance (% of GDP) 1994-1996	1997	1998 (est.)	Institutional Integration 1998
Czech Republic	19	4	46	-2.6	-6.1	-3.1	(1)(2)(3)(4)(5)
Hungary	39	38	41	-6.3	-2.2	-3.4	(1)(2)(3)(4)(5)
Poland	18	11	27	-1.0	-3.2	-4.8	(1)(2)(3)(4)(5)
Slovenia	8	0	74	1.3	0.2	0.0	(2)(3)(4)
Bulgaria	10	2	24	-0.6	4.3	-3.1	(2)(3)
Latvia	21	17	41	-3.1	-7.2	-8.6	(2)(3)
Romania	13	6	17	-2.6	-7.3	-7.3	(2)(3)
Slovakia	10	0	52	0.4	-6.9	-9.1	(2)(3)
Estonia	18	17	77	-7.1	-12.0	-10.6	(3)(4)
Kyrgyzstan	25	26	14	-20.4	-8.3	-9.2	(2)
Lithuania	27	22	47	-3.5	-10.3	-15.1	(3)
Albania	12	-21	...	-11.0	-12.2	-13.0	
Armenia	6	-18	14	-30.5	-29.0	-28.8	
Azerbaijan	7	5	16	-14.8	-23.7	-32.7	
Belarus	41	32	26	-7.6	-6.0	-7.2	
Croatia	0	-5	60	-2.4	-12.6	-9.5	
FYR Macedonia	4	7	...	-9.1	-8.3	-7.2	
Georgia	7	12	10	-19.7	-6.6	-9.3	
Kazakhstan	29	8	20	-5.0	-4.2	-8.3	
Moldova	6	-10	41	-6.1	-13.4	-16.5	
Russia	9	-2	20	1.2	0.7	1.6	
Tajikistan	12	-6	27	-8.5	-5.6	-13.5	
Turkmenistan	-26	-55	33	3.3	-32.5	-27.2	
Ukraine	3	-1	35	-4.7	-2.6	-2.6	
Uzbekistan	9	-2	12	-2.7	-5.2	-5.0	
Bosnia-Herzegovina	86	70	...	...	...	...	
CEE & NIS	12	3	25	-2.7	-3.6	-4.0	
Northern Tier CEE	21	14	37	-2.1	-4.3	-5.3	
Southern Tier CEE	16	7	24	-3.2	-6.0	-7.1	
NIS	10	0	22	-2.7	-3.1	-3.2	
European Union	7.2	8.7	61	0.7	1.5	1.2	
Advanced Economies	8.2	9.8	39	-0.2	0.3	0.2	

Benchmarks	
	(a) 3 year average export growth > 5%
	(b) 3 year average current account balance no worse than -5%

Note: Openness to trade is defined as exports plus imports expressed as a percentage of purchasing power parity GDP. Institutional integration refers to membership or participation in (1) OECD, (2) WTO, (3) Europe Agreements with EU; (4) invited to participate in the next round of negotiations toward EU membership; (5) invited to join NATO.

Source: EBRD, *Transition Report 1998* (November 1998, forthcoming); IMF, *World Economic Outlook* (October 1998, forthcoming); and World Bank, *World Development Report 1998* (September 1998).

Table 16. Integration into the World Economy (II)

Country	Foreign Direct Investment (per capita) 1989-1997	1997	1998 (est)	External Debt: Debt (% of Exports) 1994	1997	Debt Service (% of exports) 1997
Czech Republic	823	124	97	76	95	15
Hungary	1,667	207	147	375	121	44
Poland	321	79	104	248	140	6
Slovenia	639	161	101	33	50	9
Bulgaria	147	60	36	290	199	16
Estonia	692	88	139	14	115	4
Romania	150	54	41	77	94	18
Slovakia	227	9	41	70	113	17
Kyrgyzstan	67	18	6	122	148	8
Latvia	634	166	124	35	24	7
Lithuania	316	59	194	26	67	19
Albania	148	13	29	718	455	6
Armenia	79	14	58	93	337	16
Azerbaijan	425	144	147	34	73	7
Belarus	34	19	5	50	25	3
Croatia	256	41	54	66	158	12
FYR Macedonia	59	14	23	78	95	9
Georgia	95	35	49	262	333	9
Kazakhstan	361	83	77	83	68	6
Moldova	80	15	22	81	146	17
Russia	66	25	14	172	139	13
Tajikistan	12	2	3	136	111	8
Turkmenistan	162	23	26	19	179	35
Ukraine	53	12	14	55	77	9
Uzbekistan	12	3	3	37	70	10
CEE & NIS	188	43	39	142	122	10
Northern Tier CEE	596	102	110	201	119	14
Southern Tier CEE	157	48	40	171	152	15
NIS	87	27	21	122	118	8
Developing Countries				178	142	21

Benchmarks (a) below the "moderately indebted" threshold (i.e., debt < 132% of exports)
(b) debt service less than 20%

Note: Foreign Direct Investment figures for 1989-1997 are cumulative. Debt service figures for Belarus are for 1996. Data for Russia represent debt service paid; debt service paid by Russia in 1997 was 7 percent of current account revenues.

Source: EBRD, *Transition Report 1998* (November 1998, forthcoming); IMF, *World Economic Outlook* (October 1998, forthcoming); and World Bank, *World Development Report 1998* (September 1998).

2. Social Conditions

Ultimately, the sustainability of the transition hinges on the well-being of the individual. Humanitarian considerations are important. However, equally if not more compelling are the links between living standards, popular expectations, and the level of public support for economic and political reforms--reforms which have coincided with, if not contributed to, both a dramatic initial drop in overall income and significant increases in income inequalities and poverty in most cases.

Tables 17 through 23 highlight social conditions. **Unemployment** needs to be a concern. It is a relatively new phenomenon for the region, and, as *Table 17* highlights, it is significant, particularly in CEE. Subregional trends differ quite substantially, however.

For the first time since 1991, official unemployment in the Northern Tier CEE countries is below ten percent. It has been falling steadily on average since 1993. At 9.6 percent in 1997, the Northern Tier unemployment rate is more than one full percentage point below the EU average (of eleven percent). The most significant drop in the unemployment rate from 1996-1997 occurred in Poland, from 13.2 percent to 10.5 percent. The official unemployment rate in the CEE remains the lowest in the Czech Republic, though it has increased some there and is now at 5.2 percent. Slovenia has the highest unemployment rate among the Northern Tier CEE countries (14.4 percent). Despite the overall subregional trend, unemployment rates increased in Slovakia, Slovenia, and Estonia (as well as in the Czech Republic) from 1996-1997.

Some of the highest official unemployment rates of the transition economies are found in the Southern Tier CEE. The subregional unemployment rate in 1997, in fact, was more than twelve percent. The official rate is highest in Macedonia where, by this count, more than one in three persons are unemployed. Moreover, reversing a subregional trend from 1993-1996, unemployment rates increased in at least four of the five Southern Tier countries from 1996 to 1997; not enough data are available to assess the situation in Albania.

Measuring unemployment through surveys--rather than using the more commonly-available official registered unemployment figures--tends to uncover a larger problem. For example, the official unemployment rate in Romania in 1996 was close to seven percent. A household survey conducted in the early part of 1996, however, revealed unemployment to be closer to fifteen percent; that is, roughly half of those unemployed did not register as such.[7]

The official unemployment figures in the NIS are generally lower than in CEE, though they continue to increase. The relatively low unemployment rates in the NIS may reflect a combination of phenomena. One may be poorer data collection techniques. More significant is likely to be the tendency for labor markets to adjust differently in the NIS at this point in the transition. In short, underemployment (in the form of fewer work hours, involuntary leave and wage arrears) in the NIS may to some extent exist in lieu of greater open unemployment. The degree of open unemployment currently experienced in CEE may be a reflection of what is to come in the NIS. Similarly, the lower, though growing, open unemployment in the NIS may be an indication of less progress in the restructuring process.

---

[7] For further elaboration and evidence on the discrepancy between official and survey unemployment rates, see *Labor Markets in CEE: Employment, Unemployment, and Labor Hoarding*, No.2, for USAID/ENI/PCS (February 1995).

Still, the official unemployment rate is now more than ten percent in three NIS: Azerbaijan (19.3 percent in 1997); Russia (10.9 percent); and Armenia (10.7 percent). The overall NIS average increased from 6.5 percent in 1996 to 7.4 percent in 1997.

A critical consideration is the extent to which these unemployment figures represent the same people from year to year. In other words, how long are people typically unemployed? With official safety nets disappearing, we know that unemployment is a crucial determinant towards poverty. Monitoring **long-term unemployment** is hence important, and *Table 18* addresses this aspect in part for many of the CEE countries. Many data gaps exist and we can only sketch a rough picture. Forty-four percent of the unemployed in 1996 in the eight CEE countries for which data are available were unemployed for more than one year. This represents a large increase from 1992 when one in four of the unemployed were long-term unemployed, though a slight decrease from 1995. It is interesting to note that the proportion of long-term unemployment in some countries of Western Europe is also greater today than in the early 1990s. This trend, in other words, is not solely a transition phenomenon.

Long-term unemployment may be particularly troublesome for Macedonia and Albania. In 1996, eighty-one percent of those unemployed in Macedonia were unemployed for more than one year. With very high total unemployment, this translates into very high long-term unemployment: twenty-six percent. More recent data are needed to better assess the situation in Albania. In 1993, almost nineteen percent of Albania's labor force (or sixty-five percent of all those unemployed) had been unemployed for more than one year.

Tables 19 and *20* shed light on living standards through indicators of income. The first observation is that the **average income** in the transition economies is significantly below that in the advanced economies. In purchasing power parity (PPP) terms, average income in the transition region is roughly one-fifth the EU average. Furthermore, average income varies widely among the transition countries. Per capita income in Slovenia and the Czech Republic exceeds $10,000 in PPP terms; it is less than $1,000 in Tajikistan and less than $1,500 in three other countries (Albania, Moldova, and Turkmenistan). In general, average income of the Northern Tier countries is much greater than per capita income of the rest; more than two times greater than average income in the NIS, and roughly eighty percent higher than that in Southern Tier CEE.

What may be more important for our purposes is how the income levels have changed during the transition, and how it has been distributed within countries. Other things equal, the greater the income disparities and collapse in incomes, the more pronounced are the hardships and the greater is the likelihood of reform fatigue.

In this regard, it is significant to note (as shown in *Table 19*) that only a handful of countries will likely have regained pre-transition income (Poland, Slovenia, and Slovakia) or come close to regaining it (the Czech Republic and Hungary) by the end of 1998. Of the Northern Tier CEE countries, Latvia and Lithuania still have incomes considerably below pre-transition levels.

The 1998 average income in the Southern Tier CEE is roughly only three-fourths 1989 income.

The NIS lag even more; 1998 income in the NIS on average is fifty-five percent the income level of 1989. The NIS range is particularly large: current official income in Uzbekistan is almost ninety percent of 1989 income; in Moldova and Georgia, it is thirty-four percent.

We can fill in the picture further with **income distribution** data. In general, while income inequality has increased dramatically for virtually all the transition economies since communism's demise, the degree of inequality for most transition countries is roughly comparable to that found in the advanced industrialized economies. These were highly egalitarian societies prior to the collapse of communism.

Of the transition subregions, income inequality was the greatest in the NIS at the outset of the transition and yet has increased the most in the NIS during the transition (by almost fifty percent). This compares to a roughly thirty-three percent increase in income inequality in CEE from 1989 to 1996 and to a two percent increase in the EU over a comparable period of time.

The distribution of income is the most unequal in Russia, followed by Kyrgyzstan and Ukraine. Income inequality in these countries compares to that found in the most unequal economies worldwide, that is, those in Latin American and in Sub-Sahara Africa.

Among the transition economies, income looks to be most equally distributed in parts of the pre-transition Yugoslavia (Macedonia and Croatia, in particular) and in the former Czechoslovakia.

An additional important part of the income picture is the unofficial economy. Income from the unofficial economy serves to cushion official income losses. In fact, according to Johnson, Kaufmann, and Shleifer (1997), many of those countries which have experienced a particularly large decrease in official economic activity have also seen relatively large increases in unofficial economic activity.[8] According to their estimates the unofficial economy is significant in all seventeen transition countries included in the sample. However, the variation across the countries is also significant. In the NIS, the unofficial economy is almost forty percent of overall official economic activity; in CEE, it is closer to twenty percent.

The two regions differ substantially in trends over time in the unofficial economy as well. The growth of the unofficial economy has likely peaked for many of the CEE countries, particularly the Northern Tier countries (perhaps except Latvia). In fact, from 1989-1995, the growth of the unofficial economy in CEE has been negligible. In contrast, the unofficial economy on average in the NIS has more than tripled from 1989 to 1995 and is likely still growing in most of the NIS.

Poverty has increased substantially in the transition region as shown in *Table 20.* Moreover, these estimates from the World Bank tend to be quite low relative to some others. UNICEF, for example, cites a percentage point increase in poverty rates from 1989 to 1994 in: Lithuania by 64.7

---

[8] S. Johnson, D. Kaufmann, and A. Shleifer, "Politics and Entrepreneurship in Transition Economies," *Working Paper Series*, No. 57, The William Davidson Institute, University of Michigan (1997). *Appendix II* of *Monitoring Country Progress* (January 1998) summarizes the study and *Appendix II* of this edition provides a graphical sketch of unofficial economy trends by subregions from these data.

percent; Latvia by 55.1 percent; Moldova by 54.9 percent; Azerbaijan by 50 percent; Bulgaria by 49.7 percent; Estonia by 46.0 percent; Russia by 45.5 percent; Romania by 31.7 percent; Slovakia by 27.2 percent; the Czech Republic by 22.5 percent; Hungary by 12.4 percent; and Poland by 12.2 percent.[9]

According to World Bank estimates for 1993-1995, four out of every ten persons in the transition region are poor. However, this average masks very wide variation, by country and by groups within countries. Poverty remains negligible in Slovenia, the Czech Republic, and Slovakia. In contrast, at least seven transition economies, all NIS, have poverty rates equal to or greater than fifty percent: Tajikistan, Kyrgyzstan, Moldova, Ukraine, Kazakhstan, Turkmenistan, and Azerbaijan. Poverty in Russia (forty-four percent in 1995) may not be much lower. In fact, on average, one of every two persons in the NIS were poor in 1993-1995. In the Northern Tier CEE countries, it is closer to one of every ten persons, and in the Southern Tier, one out of every four. More recent data may reveal an even wider gap between subregions.

---

9 UNICEF, *Poverty, Children and Policy: Responses for a Brighter Future*, Economies in Transition Studies, Regional Monitoring Report No. 3 (1995).

One reason why the poverty estimates vary widely by country is because much of the poverty is apparently shallow. That is, many of the poor are only marginally so, and a relatively small change in the poverty line, can result in a relatively large change in the poverty rate.[10] There may be a significant turnover among those found in poverty as well.[11] Both trends have favorable implications for policy; both need to be explored further. It is important to underscore, however, that deep, albeit perhaps relatively small, pockets of poverty can coincide with poverty that for most people is shallow. Moreover, as the transition goes on, particularly in the NIS where transition costs continue to mount, the incidence of deepening, sustained poverty needs close monitoring.

Table 20 also reveals that a disproportionate burden from poverty is placed on different segments of society. The poverty estimates for children and the elderly cannot be directly compared with the country-wide estimates since the methods to calculate are different. A comparison between poverty among children with that of the elderly and how those rates have changed since 1989, however, is very revealing.

In general, the data suggest that poverty is much greater among children than it is among the elderly. This is the case in six of the eight countries for which data exist for 1992-1995. By this measure, poverty among Russian children increased from forty percent to over sixty percent since roughly 1990; from two percent to over forty percent in Bulgaria; nine percent to thirty-five percent in Romania; eight percent to twenty percent in Poland.

Poverty rates for the elderly on average in this limited sample are one-half that of children. Among the Northern Tier countries, poverty among the elderly is low and may actually be decreasing: four percent in 1989-1992 to three percent in 1992-1995. It may be that the elderly in some of these countries remain politically strong enough to be able to favorably influence pension rates and eligibility.

Table 21 highlights trends in infant mortality rates and life expectancy. For most countries, **infant mortality rates** have fallen from 1989 to 1996. The rates were the lowest in the Northern Tier CEE countries at the outset of the transition and have fallen the most there during the transition. Northern Tier infant mortality rates in 1996 (10.8 deaths per 1,000 live births) are slightly above the OECD average (8.4 deaths). Two transition countries--Latvia and Albania--have witnessed a significant increase in the infant mortality rate from 1989 to 1996, while three countries--Bulgaria, Belarus, and Ukraine--have experienced a more moderate increase. Infant mortality rates remain particularly high in the Central Asian Republics (thirty deaths per 1,000 live births on average in 1996), and in Albania (thirty-seven deaths).

Life expectancy trends in the three transition subregions are consistent with average income trends. From 1989 to 1996, life expectancy has increased in the Northern Tier (for females and males); it has changed little on balance in the Southern Tier CEE (small decrease among males and small increase among females); and it has fallen significantly in the NIS (particularly among the

---

10 A World Bank study cites an increase in poverty in Hungary from 2% in 1989 to over 8% in 1993, using the minimum pension as the poverty line. A poverty line set at roughly one and half times the minimum pension, however, translates into a poverty rate from less than 5% in 1989 to anywhere from 33-40% in 1993. World Bank, *Hungary: Poverty and Social Transfers* (March 14, 1996).

11 This conclusion at any rate would seem to apply to Russia. See: World Bank, *Poverty in Russia: An Assessment*, Human Resources Division, June 1995.

males). The greatest drops in life expectancy have occurred among males in Russia, Kazakhstan, Ukraine, Belarus, and Estonia. One aspect to this trend is oftentimes severe hardships for the surviving widows.

As with physical capital, human capital is important for its direct effect on economic sustainability (*Table 22)*. It too, however, can provide indications of trends in living standards. **Secondary school enrollment** has increased from 1990 to 1995 in most of the Northern Tier CEE countries, while decreasing in most other transition countries. Greatest drops have occurred in Albania, Georgia, Romania, Moldova, Lithuania, and Russia. Secondary school enrollment in the Northern Tier CEE (at ninety-two percent) is above the EU average (of ninety percent). While dropping on average, it is still high in the NIS (eighty-seven percent). At sixty-seven percent, it is lowest in the Southern Tier CEE countries.

Table 22 also highlights trends in the UNDP's **Human Development Index** (HDI). The HDI is based on three indicators: longevity, as measured by life expectancy; educational attainment, as measured by a combination of adult literacy (two-thirds weight), and combined primary, secondary and tertiary enrollment ratios (one-third weight); and standard of living, as measured by real GDP per capita (PPP$). The HDI ranges from 0 to 1; the higher is the value, presumably the greater is the human development.

The UNDP classifies 174 countries into three categories in the *Human Development Report 1998*: high; medium; and low human development. It is based on 1995 data. Human development is considered to be high in five transition countries (Slovenia, Czech Republic, Slovakia, Hungary, and Poland), and medium in the rest.

HDI trends over time may be revealing, though more recent data would be helpful. The large majority of the transition countries saw their global ranking deteriorate from 1993 to 1995, though some of this is attributed to an increase in sample size in the most recent calculations. Perhaps more revealing are the trends in the scores from year to year. All but two CEE countries--Latvia and Croatia--showed an increase in the HDI score between the two time periods. In contrast, all the NIS saw a decrease in the HDI score.

Finally, *Table 23* sheds some light on environmental developments. Environmental degradation was pervasive under central planning. A focus on maximizing production with little or no regard for environmental consequences and with a strong emphasis on heavy industry and highly energy-intensive methods contributed to much of this. Obviously, environmental degradation affects the quality of life and may have bearing on public support for the transition reforms. However, increasing productivity and efficiency are also important byproducts from more environmentally sound policies.

Integral to this for the CEE countries in particular is membership into the EU which will require gradual adoption of the EU's environmental regulations. Substantial investments will likely need to accompany the establishment of a viable regulatory regime and appropriate energy prices. A 1993 study of six CEE countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania, and Slovakia) estimated environmental investments of fifteen to twenty percent of GDP to bring them up to EU standards.[12]

While we have far to go towards better monitoring the environment in the transition economies, *Table 23* fills in a small part of the picture by addressing in part **environmental efficiency and quality**. More efficient use of natural resources (that is, greater environmental efficiency) should translate into lower pollution, at least on a unit of production basis. Energy and water use intensity seem to be reasonable measures of this efficiency.

For this measure, **electricity intensity** of output in 1994 is examined. The electric power sector is a major source of air pollution in the transition region, particularly in those countries that rely primarily on coal, lignite, and oil shale as their primary energy source.

Table 23 reveals substantial differences in electricity intensity of output in 1994 between the transition countries and the industrial market economies, as well as within the transition region. Electricity intensity in CEE is twice as high as that found in the EU; in the NIS, it is more than three times higher. Electricity intensity is highest in the Central Asian Republics and Azerbaijan where energy resources are plentiful. Electricity intensity is highest among CEE countries in Bulgaria and Lithuania which rely heavily on nuclear power generation (and where nuclear safety needs to be a big concern).

Table 23 also shows **carbon dioxide emissions** (per unit of GDP and per capita), and annual mean concentrations of three **common air pollutants**--sulphur dioxide, nitrogen dioxide, and total suspended particulates--in parts per million for major cities in eighteen transition countries and thirteen Western Europe countries. Such emissions are used as proxies for environmental quality.

12 Environmental Resource Management, *Environmental Standards and Legislation in Western and Eastern Europe: Towards Harmonization*, Final Report prepared for EBRD/EU-Phare, December 1993.

Most of these indicators show air pollution to be much higher in the transition countries than in the EU. This applies in particular to sulphur dioxide emissions, TSP concentrations, and carbon dioxide emissions per GDP. Air pollution tends to be higher in the NIS than in CEE. Finally, carbon dioxide emissions per capita decreased in many countries from 1992 and 1995. This coincides with the findings of a 1994 Bureau of Census study which reported a decrease in air pollution emissions in several CEE countries (with the apparent exception of the Czech Republic) in the early transition years.[13] Such a trend, however, is likely attributed in large part to an overall drop in production. More recent figures might reveal increasing pollution coinciding with economic growth.

[13] Bureau of Census, *Populations at Risk in CEE: An Overview*, No. 1, prepared for USAID/ENI/PCS (November 1994).

Table 17. Unemployment Rate

	1991	1992	1993	1994	1995	1996	1997	1995-1997 (average)
CEE:								
Czech Republic	4.1	2.6	3.5	3.2	2.9	3.5	5.2	3.9
Lithuania	0.3	1.3	4.4	3.8	6.2	7.1	5.9	6.4
Latvia	...	2.3	5.8	6.5	6.6	7.2	7.0	6.9
Romania	3.0	8.2	10.4	10.9	9.5	6.6	8.8	8.3
Estonia	...	...	6.5	7.6	9.7	10.0	10.5	10.1
Hungary	7.4	12.3	12.1	10.4	10.4	10.5	10.4	10.4
Slovakia	...	...	12.2	13.7	13.1	11.1	11.6	11.9
Bulgaria	11.1	15.3	16.4	12.8	11.1	12.5	13.7	12.4
Poland	11.8	13.6	16.4	16.0	14.9	13.2	10.5	12.9
Slovenia	8.2	11.5	14.4	14.4	13.9	13.9	14.4	14.1
Albania	8.3	27.9	29.0	19.6	16.9	12.4	...	14.7
Croatia	13.2	13.2	14.8	14.5	14.5	16.4	17.5	16.1
FYR Macedonia	19.2	27.8	28.3	31.4	37.7	31.9	36.0	35.2
NIS:								
Uzbekistan	0.0	0.1	0.3	0.4	0.4	0.4	0.5	0.4
Ukraine	0.0	0.3	0.4	0.4	0.5	1.1	2.3	1.3
Moldova	...	0.1	0.7	1.1	1.4	1.8	1.6	1.6
Tajikistan	...	0.3	1.2	1.7	2.0	2.7	2.9	2.5
Turkmenistan	2.0	...	...	...	3.0	...	...	3.0
Belarus	0.1	0.5	1.4	2.1	2.7	3.9	2.8	3.1
Kazakhstan	0.0	0.5	0.6	0.8	1.7	3.6	4.1	3.1
Kyrgyzstan	0.0	0.1	0.2	0.7	3.0	4.5	3.2	3.6
Georgia	0.2	2.3	6.6	3.6	2.6	11.6	5.2	6.5
Armenia	...	1.8	5.3	6.7	6.7	9.2	10.7	8.9
Russia	0.0	4.8	5.3	7.1	8.3	9.2	10.9	9.5
Azerbaijan	...	15.4	16.0	15.2	17.0	19.4	19.3	18.6
CEE & NIS	2.4	5.4	6.4	6.9	7.3	7.7	8.3	7.7
Northern Tier CEE	9.1	10.6	12.5	12.2	11.7	10.8	9.6	10.7
Southern Tier CEE	7.0	12.8	14.5	13.4	12.4	10.6	12.4	11.9
NIS	0.0	3.1	3.6	4.6	5.4	6.5	7.4	6.4
Advanced Economies	6.6	7.3	7.7	7.6	7.2	7.3	7.1	7.2
U.S.	6.8	7.5	6.9	6.1	5.6	5.4	4.9	5.3
EU	8.5	9.9	11.1	11.6	11.2	11.3	11.0	11.2
Benchmarks								< 10.0

Source: EBRD, Transition Report 1998 (November 1998, forthcoming); IMF, World Economic Outlook (October 1998, forthcoming).

Table 18. Long-Term Unemployment in CEE

Country	% of Labor Force 1992	1993	1994	1995	1996	% of Total Unemployed 1992	1993	1994	1995	1996	Percent Change: 1992 to 1996
Albania	...	18.9	...	...	...	…	65	…	…	...	...
Bulgaria	...	8.7	7.6	7.3	8.0	…	53	59	66	64	21
Croatia	7.7	8.6	8.0	...	...	58	58	55	…	...	-5
Czech Republic	0.4	0.7	0.7	0.9	1.2	14	19	22	31	33	136
Estonia	...	...	...	...	...	…	…	…	…	...	...
Hungary	2.2	4.0	4.3	5.0	5.5	18	33	41	48	52	189
Latvia	...	...	...	...	...	…	…	…	…	...	...
Lithuania	...	...	...	...	...	…	…	…	…	...	...
FYR Macedonia	23.9	24.6	27.6	30.9	25.8	86	87	88	82	81	-6
Poland	3.3	5.9	6.1	6.3	5.0	24	36	38	42	38	58
Romania	1.7	...	4.9	4.5	2.8	21	…	45	47	42	100
Slovakia	...	4.0	5.9	7.1	6.2	…	33	43	54	56	70
Slovenia	5.3	7.9	8.2	7.4	7.4	46	55	57	53	53	15
Northern Tier CEE	2.7	4.7	5.0	5.3	4.7	22	33	37	43	41	87
Southern Tier CEE	4.2	12.2	7.1	6.8	5.5	31	60	52	54	50	59
CEE Overall	3.2	6.3	5.8	5.8	4.9	25	39	42	46	44	76
France	3.7	3.9	4.7	5.3	4.7	36	34	38	40	38	6
Germany	2.5	3.6	4.2	4.5	...	33	36	38	40	...	21
Spain	8.6	11.4	13.6	13.1	...	47	50	56	57	...	21
Sweden	0.4	0.9	1.4	1.2	1.4	8	11	17	16	17	113
UK	...	...	...	...	2.9	30	38	40	38	36	20
Benchmark	Long-term unemployment less than 8% of the labor force										

Note: The long-term unemployed are those who are unemployed for more than one year. Percent change figures cover the period for which data are available. Source: World Bank, *World Development Indicators 1998* (March 1998); C. Allison and D. Ringold, *Labor Markets in Transition in Central and Eastern Europe: 1989-1995;* World Bank, Social Challenges of Transition Series (December 1996); and Bureau of the Census, *Populations at Risk in CEE: Labor Markets*, No. 2, prepared for USAID/ENI/PCS (February 1995).

Table 19. Income and Its Distribution

	1997 Average Income		Distribution of Income				1998/1989
	US$	PPP$	89/90	92/93	95/6	89 - 96 % change	GDP (%)
Poland	3,510	6,380	21	26	29	32	118
Slovenia	9,000	12,520	22	28	30	31	102
Slovakia	3,620	7,850	20	20	...	0	100
Czech Republic	5,050	11,380	20	26	27	30	99
Hungary	4,460	7,000	27	32	...	23	95
Albania	710	1,300	...	...	...	...	88
Uzbekistan	610	2,450	28	33	...	16	88
Estonia	3,230	5,010	23	40	...	54	83
Croatia	4,270	4,570	25	27	...	8	80
Romania	1,550	4,290	16	23	30	61	79
Belarus	1,310	4,840	23	40	...	54	75
Bulgaria	1,230	3,860	21	25	29	32	65
Kazakhstan	1,340	3,290	26	33	...	24	63
Lithuania	2,580	4,510	26	37	35	30	63
Kyrgyzstan	370	2,040	26	45	43	49	60
FYR Macedonia	1,660	2,180	22	27	25	13	59
Latvia	2,210	3,650	24	28	35	37	58
Russia	3,060	4,190	27	46	48	56	56
Turkmenistan	390	1,410	26	36	...	32	44
Azerbaijan	510	1,520	...	...	...	...	42
Tajikistan	180	930	...	...	...	...	41
Armenia	440	2,280	26	37	38	38	40
Ukraine	980	2,170	25	36	41	48	37
Georgia	970	1,980	30	40	...	29	34
Moldova	500	1,460	25	44	39	44	34
CEE & NIS	2,330	4,110	25	37	41	43	66
Northern Tier CEE	3,920	7,230	22	27	29	29	105
Southern Tier CEE	1,730	3,890	22	26	31	36	76
NIS	2,000	3,330	26	42	46	48	55
Advanced Economies	25,100	22,700		32		3	
EU	21,830	19,970		28		2	
Benchmark	(a) current year GDP equal to 85% of 1989 GDP						

Note: Average (or per capita) income is measured in US$ converting through official exchange rates; and through purchasing power parity (PPP) figures. Income distribution is measured by the Gini Coefficient, which ranges from 0 to 100; the higher the figure, the greater the inequality. The percent change in distribution of income in the transition economies is for 1989-1993 when 1995/6 data are not available. For the Advanced Economies and the EU, percent change in income distribution is roughly from 1986 to 1993.

Source: EBRD, *Transition Report 1998* (November 1998, forthcoming) and previous editions; World Bank, *World Development Report 1998/99* (November 1998); UNICEF, *Education for All?,* The MONEE Project, #5 (1998); P. Gottschalk and T. Smeeding, "Cross-National Comparisons of Earnings and Income Inequality," *Journal of Economic Literature* 35 (June 1997), pp. 633-687; *Economist Intelligence Unit* reports (most recent).

Table 20. Poverty
Percent of Population Living in Poverty

Country	Children 1989-1992	Children 1992-1995	Elderly 1989-1992	Elderly 1992-1995	Overall 1987-1988	Overall 1993-1995
Czech Republic	0	1	0	1	0	< 1
Slovakia	0	9	0	1	0	< 1
Slovenia	8	…	7	…	0	< 1
Hungary	2	7	1	1	1	2
Poland	8	20	5	3	6	14
Bulgaria	2	43	4	28	2	15
Belarus	…	…	…	…	1	22
Latvia	51	…	15	…	1	22
Romania	9	35	12	19	6	28
Lithuania	…	…	…	…	1	30
Estonia	27	34	38	38	…	37
Uzbekistan	…	…	…	…	24	39
Armenia	…	…	…	…	…	40
Georgia	…	…	…	…	…	40
Russia	40	62	23	34	2	44
Azerbaijan	73	…	65	…	…	50
Turkmenistan	…	…	…	…	12	57
Kazakhstan	…	…	…	…	5	62
Ukraine	…	…	…	…	2	63
Moldova	3	…	3	…	4	66
Kyrgyzstan	…	…	…	…	12	86
Tajikistan	…	…	…	…	…	100
Albania	…	…	…	…	…	…
Croatia	…	…	…	…	…	…
FYR Macedonia	…	…	…	…	…	…
CEE & NIS	28	46	17	24	4	40
Northern Tier CEE	7	14	4	3	3	11
Southern Tier CEE	7	37	10	21	5	24
NIS	41	62	24	34	4	50
UK					1	
Turkey					31	
Malaysia					15	
Brazil					33	

Note: Overall poverty rates for most countries measure the percent of population below poverty line of $120 per capita per month at 1990 international prices; for Armenia, Azerbaijan, Georgia and Tajikistan the poverty threshold is $100 per month. For children and elderly, the poverty threshold is roughly 25 percent of the average 1989 wage, and hence is not directly comparable with overall poverty rates.

Source: Branko Milanovic, *Income, Inequality, and Poverty during the Transition from Planned to Market Economy* (World Bank, 1998); UNICEF, *Poverty, Children, and Policy: Reponses for a Brighter Future*, Economies in Transition: Regional Monitoring Report 3 (1995); UNDP, *Poverty in Transition?* (July 1998); UNDP, *Human Development Report 1997* (May 1997); and Bureau of the Census, *Populations at Risk*, No. 5, for ENI/PCS (July 1996).

Table 21. Infant Mortality and Life Expectancy

	Infant Mortality				Life Expectancy					
				% Change	Male			Female		
	1989	1991-93	1996	1989-96	1989	1996	% change	1989	1996	% change
Czech Republic	10	10	6	-40	68	70	3.1	75	77	2.3
Slovenia	8	8	5	-38	69	71	2.9	77	78	2.1
Slovakia	14	12	11	-21	67	69	2.8	75	77	1.7
Poland	19	17	12	-37	67	68	1.5	76	77	1.5
Armenia	20	18	16	-20	69	69	0.4	75	76	2.0
Turkmenistan	...	46	41	-11	62	62	0.8	68	69	1.3
Georgia	20	15	17	-15	68	69	0.6	76	77	1.2
FYR Macedonia	...	28	16	-43	70	70	0.4	74	75	1.2
Croatia	...	12	9	-25	68	68	0.0	76	77	1.6
Tajikistan	...	45	32	-29	66	66	-0.5	71	72	1.4
Hungary	16	14	11	-31	65	65	0.0	74	75	0.9
Uzbekistan	...	35	24	-31	66	66	0.2	72	72	0.4
Romania	27	23	22	-19	67	65	-2.0	73	73	0.6
Albania	31	32	37	19	70	69	-1.1	76	75	-1.1
Latvia	11	16	16	45	65	63	-3.1	75	76	0.7
Azerbaijan	26	26	20	-23	66	65	-2.6	74	74	-0.3
Bulgaria	14	16	16	14	69	67	-2.2	75	75	-0.7
Lithuania	11	15	10	-9	67	65	-2.8	76	76	-0.3
Estonia	15	15	10	-33	66	63	-4.6	75	76	1.1
Kyrgyzstan	...	31	26	-16	64	62	-3.0	72	71	-1.1
Moldova	20	20	20	0	66	64	-2.3	72	71	-1.8
Belarus	12	12	13	8	67	63	-6.0	76	74	-2.5
Ukraine	13	14	14	8	66	62	-5.7	75	73	-2.9
Kazakhstan	...	27	25	-7	64	60	-6.3	73	71	-3.3
Russia	18	18	17	-6	64	60	-7.2	75	73	-2.4
CEE & NIS	...	19	17.1	-12	66	63	-3.7	74	74	-1.1
Northern Tier CEE	15.9	15	10.8	-31	67	68	1.2	75	76	1.4
Southern Tier CEE	24.2	21	20.2	-11	68	67	-1.0	74	74	0.3
NIS	...	20	18.3	-6	65	61	-5.4	74	73	-2.0
LDCs			60.0			62			64	
Middle-income			39.0			65			71	
OECD			8.4			74			81	
EU			5.6							
Benchmarks			30.0	no worsening			no worsening			no worsenin

Note: Infant mortality rate is per 1,000 live births; and life expectancy is in years. The OECD infant mortality rate average is significantly pulled up by 2 members: Turkey at 42 & Mexico at 32. Percent change in infant mortality is calculated from 1991-93 to 1996 when 1989 data are not available.

Source: World Bank, World Development Indicators 1998 (March 1998); World Bank, World Development Report (June 1997 & 1996).

Table 22. Human Development

Country	Secondary School Enrollment (% of age group) 1990	1993	1995	% change	Human Development Index 1993 Score	1993 Rank	1995 Score	1995 Rank
Slovenia	80.3	82.9	91.0	12.5	*0.886*	*35*	0.887	37
Czech Republic	79.6	88.5	96.0	18.7	0.872	37	0.884	39
Slovakia	88.2	93.2	91.0	3.1	0.864	41	0.875	42
Hungary	74.5	78.2	81.0	8.4	0.855	46	0.857	47
Poland	77.8	80.6	96.0	20.9	0.819	56	0.851	52
Bulgaria	77.0	70.6	78.0	1.3	0.773	62	0.789	67
Belarus	86.0	84.0	...	-2.4	0.787	61	0.783	68
Russia	95.3	91.4	87.0	-9.1	0.804	57	0.769	72
Romania	81.9	75.2	66.0	-21.5	0.738	74	0.767	74
Croatia	77.0	83.0	82.0	6.3	*0.760*	*77*	0.759	76
Estonia	88.8	83.7	86.0	-3.2	0.749	68	0.758	77
Lithuania	93.4	82.7	84.0	-10.6	0.719	81	0.750	79
FYR Macedonia	53.0	54.0	57.0	7.3	*0.748*	*80*	0.749	80
Latvia	83.5	79.0	85.0	1.8	0.820	55	0.704	92
Kazakhstan	...	90.0	83.0	-8.1	0.740	72	0.695	93
Armenia	...	85.0	79.0	-7.3	0.680	93	0.674	99
Ukraine	61.2	44.8	91.0	39.2	0.719	80	0.665	102
Turkmenistan	...	...	...	...	0.695	90	0.660	103
Uzbekistan	...	94.0	93.0	-1.1	0.679	94	0.659	104
Albania	78.0	...	35.0	-76.1	0.633	104	0.656	105
Georgia	94.9	75.9	73.0	-26.1	0.645	101	0.633	108
Kyrgyzstan	...	...	81.0	...	0.663	99	0.633	109
Azerbaijan	76.0	75.0	74.0	-2.7	0.665	96	0.623	110
Moldova	90.0	85.0	80.0	-11.8	0.663	98	0.610	113
Tajikistan	...	...	82.0	...	0.616	105	0.575	118
CEE & NIS	84.0	81.0	85.9	2.2	0.75		0.75	
Northern Tier CEE	79.6	82.5	92.3	14.8	0.81		0.85	
Southern Tier CEE	78.6	74.0	67.3	-15.5	0.74		0.76	
NIS	86.5	81.6	86.9	0.6	0.76		0.72	
EU			90.0		0.92		0.93	...
Colombia							0.85	53
Ecuador							0.77	73
Dominican Republic							0.72	88
Benchmark		no decline in enrollment						

Note: Change in secondary school enrollment for Kazakhstan, Armenia, and Uzbekistan is from 1993 to 1995; for Belarus, from 1990 to 1993. The HDI ranges from 0 to 1; the higher the value, the greater the human development. HDI figures for Croatia, FYR Macedonia, and Slovenia are for 1994 and 1995.

Source: World Bank, *World Development Report 1996* (June 1996); UNICEF, *Education for All?*, The MONEE Project, #5 (1998); UNDP, *Human Development Report* (September 1998 and earlier editions).

Table 23. Environment

Country	Environmental Quality: CO_2 Emissions per capita (1992)	CO_2 Emissions per capita (1995)	CO_2 Emissions per unit of GDP (1995)	Air Pollution Concentrations (1995) micrograms/m^3: City	SO_2	NO_2	TSP	Efficiency: Electricity Intensity (1994)
Albania	1.2	0.6	1.0	...	...	...	...	400
Latvia	5.6	3.7	1.9	...	...	...	...	450
Croatia	3.4	3.6	...	Zagreb	31	...	71	540
Hungary	5.8	5.5	2.3	Budapest	39	51	63	550
Slovenia	2.8	5.9	...	...	...	...	...	600
Poland	8.9	8.8	5.1	Warsaw	16	32	...	650
(Poland)	...	...	...	Katowice	83	79	...	…
(Poland)	...	...	...	Lodz	21	43	...	
Armenia	1.1	1.0	3.4	…	...	...	...	700
Belarus	9.9	5.7	3.4	...	...	...	...	700
Slovakia	7.0	7.1	2.3	Bratislava	21	27	62	700
Czech Republic	13.1	10.8	3.4	Prague	32	23	59	710
Estonia	13.5	11.1	4.3	…	...	...	...	750
Romania	5.4	5.3	3.9	Bucharest	10	71	82	840
Moldova	3.3	2.5	...	...	...	...	...	850
Uzbekistan	5.7	4.3	7.3	…	...	...	...	860
Lithuania	5.9	4.0	2.1	...	...	...	...	950
Bulgaria	6.4	6.7	2.5	Sofia	39	122	195	1,000
Russia	14.1	12.3	6.1	Moscow	109	...	100	1,100
(Russia)	...	...	...	Omsk	9	30	100	…
Ukraine	11.7	8.5	...	Kyiv	14	51	100	1,180
FYR Macedonia	2.0	...	...	…	...	...	...	1,200
Georgia	2.5	1.4	...	…	...	...	...	1,300
Kyrgyzstan	3.4	1.2	4.9	…	...	...	...	1,300
Azerbaijan	8.7	5.7	14.6	…	...	...	...	1,400
Kazakhstan	17.6	13.3	13.8	…	...	...	...	1,400
Turkmenistan	10.5	6.3	...	…	...	...	...	1,900
Tajikistan	0.7	0.6	2.5	…	...	...	...	2,005
Bosnia-Herzegovina	...	0.4	...		...	...	...	
Yugoslavia	...	3.1	...		...	...	...	
CEE & NIS	10.5	8.6	5.8		35	53	92	1,010
Northern Tier CEE	8.6	8.1	4.0		35	43	61	660
Southern Tier CEE	4.9	4.3	3.3		27	97	116	820
NIS	11.8	9.6	6.8		44	41	100	1,130
European Union	...	8.0	0.6		12	46	47	350

Note: CO_2 emissions are measured in metric tons per capita and kg per dollar of GDP (in constant 1987 dollars). Air pollution concentrations are annual mean concentrations of sulphur dioxide (micrograms/m^3 of SO_2), nitrogen dioxide (micrograms/m^3 of NO_2), and total suspended particulates (micrograms/m^3 of TSP) for major cities in 1995. EU average is derived from data for 13 countries. Electricity intensity refers to the 1994 electricity consumption per $US 1,000 of GDP at PPP exchange rates (1993 for Tajikistan, Turkmenistan, Georgia, Uzbekistan, and Albania).

Source: World Bank, *World Development Indicators 1998* (March 1998); EBRD, *Transition Report 1996* (November 1996).

IV. Concluding Remarks

Decisions on the magnitude and duration of U.S. assistance to the ENI region are made on the basis of several factors:

(a) progress the country has made toward a sustainable transition to a market-based democracy;

(b) strategic importance of the country to the United States;

(c) importance of the recipient country to U.S. citizens; and

(d) effectiveness of particular assistance activities.

This paper has presented an approach to analyzing the first factor. The second and third are not as readily quantifiable but are matters of judgment that are regularly considered, along with the first, in making country-level budget decisions. The fourth factor, based on both regular reporting against strategic objective targets and on occasional field-based evaluations, is used primarily to inform the allocation of country budget levels among strategic objectives but is also a basis for determining whether a country assistance program is having enough impact to warrant continuation.

USAID collects, analyzes, and reports on the country performance indicators two times a year. Inter-agency reviews are held as a means to assess the data and to better take stock of progress in the region. These data are also provided to the State Department-based Coordinators for U.S. Assistance to CEE and the NIS and discussed with them when country planning levels are determined.

The overall rankings of the ENI countries in terms of economic policy reforms and democratic freedoms (as depicted in *Table 9*) provide a rough guide to policy in this regard. Countries ranked near the top of the list are obvious candidates for earlier graduation. Countries near the bottom of the list would seem to fall into one of three contrasting categories: (1) those where assistance is least likely to be effective, in which case it may make sense to close those programs down altogether or to keep highly targeted funding at minimal levels until their commitment to reform increases; (2) these where reform now appears likely but requires greater resources; or (3) those which possess characteristics that match well with the Agency's priorities for sustainable development programs. Countries in the middle of the list are likely candidates for continuing programs through existing funding mechanisms, as long as the assistance is effective and Congress continues to appropriate funds for this purpose.

In addition, by looking beyond the aggregate rankings and developing a decision tree methodology, this paper attempts to more rigorously devise criteria towards graduation from U.S. assistance. First, do the countries achieve some acceptable level of progress in both economic policy reforms and democratization? Acceptable thresholds must occur in both before we consider sustainability.

Next, are the economic policy reforms translating into robust and sustainable macroeconomic outcomes? In addition, are trends in the social conditions such that the economic and political reforms are not likely to be thwarted or side-tracked?

APPENDIX I: ECONOMIC & DEMOCRATIC REFORM INDICATORS

A. Economic Policy Reforms: Indicators & Description of EBRD's Rating Categories

First Round Reforms

Small-scale Privatization
1 Little progress
2 Substantial share privatized
3 Nearly comprehensive program implemented, but design or lack of government supervision leaves important issues unresolved (e.g. lack of tradability of ownership rights)
4 Complete privatization of small companies with tradable ownership rights
5 Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land

Price Liberalization
1 Most prices formally controlled by the government
2 Price controls for several important product categories, including key infrastructure products such as utilities and energy; state procurement at non-market prices remains substantial
3 Substantial progress on price liberalization including for energy prices; state procurement at non-market prices largely phased out
4 Comprehensive price liberalization; utility pricing ensuring cost recovery
5 Standards and performance typical of advanced industrial economies: comprehensive price liberalization; efficiency-enhancing regulation of utility pricing

Trade & Foreign Exchange System
1 Widespread import and/or export controls or very limited legitimate access to foreign exchange
2 Some liberalization of import and/or export controls; almost full current account convertibility in principle but with a foreign exchange regime that is not fully transparent (possibly with multiple exchange rates)
3 Removal of most quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services.
4 Removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services
5 Standards and performance norms of advanced industrial economies: removal of most tariff barriers; membership in WTO

Second Round Reforms

Large-scale Privatization

1 Little private ownership
2 Comprehensive scheme almost ready for implementation; some sales completed
3 More than 25 percent of large-scale state-owned enterprise assets privatized or in the process of being sold, but possibly with major unresolved issues regarding corporate governance
4 More than 50 percent of state-owned enterprise assets privatized in a scheme that has generated substantial outsider ownership
5 Standards and performance typical of advanced industrial economies: more than 75 percent of enterprise assets in private ownership with effective corporate governance

Governance & Enterprise Restructuring

1 Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance
2 Moderately tight credit and subsidy policy but weak enforcement of bankruptcy legislation and little action taken to break up dominant firms
3 Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (e.g. through privatization combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation)
4 Strong financial discipline at the enterprise level; substantial improvement in corporate governance through government restructuring program or an active corporate control market; significant action to break up dominant firms; significant new investment at the enterprise level
5 Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring

Third Round Reforms

Competition Policy

1 No competition legislation and institutions; widespread entry restrictions
2 Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms
3 Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions
4 Significant enforcement actions to reduce abuse of market power and to promote a competitive environment
5 Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets

Banking Reform

1 Little progress beyond establishment of a two-tier system
2 Significant liberalization of interest rates and credit allocation; limited use of directed credit or interest rate ceilings
3 Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalization with little preferential access to cheap

refinancing; significant lending to private enterprises and significant presence of private banks
4 Significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening
5 Standards and performance norms of advanced industrial economies: full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services

Non-Bank Financial Institutional Reform
1 Little progress
2 Formation of securities exchanges, market-makers and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities
3 Substantial issuance of securities by private enterprises; establishment of independent share registries, secure clearance and settlement procedures, and some protection of minority shareholders; emergence of non-bank financial institutions (e.g. investment funds, private insurance and pension funds, leasing companies) and associated regulatory framework
4 Securities laws and regulations approaching IOSCO standards; substantial market liquidity and capitalization; well-functioning non-bank financial institutions and effective regulation
5 Standards and performance norms of advanced industrial economies: full convergence of securities laws and regulations with IOSCO standards; fully developed non-bank intermediation

Legal Reform for Investment

(a) Extensiveness:
1 Legal rules concerning pledge, bankruptcy and company law are very limited in scope. Laws impose substantial constraints on the creation, registration and enforcement of security over movable assets, and may impose significant notarization fees on pledges. Company laws do not ensure adequate corporate governance or protect shareholders' rights. Bankruptcy laws do not provide for certainty or clarity with respect to the definition of an insolvent debtor, the scope of reorganization proceedings or the priority of distribution to creditors following liquidation. Laws in these substantive areas often have not been amended to approximate those of more developed countries and the laws that have been amended contain ambiguities or inconsistencies.
2 Legal rules concerning pledge, bankruptcy and company law are limited in scope and are subject to conflicting interpretations. Legislation may have been amended but new laws do not necessarily approximate those of more developed countries. Specifically, the registration and enforcement of security over movable assets has not been adequately addressed, leading to uncertainty with respect to the registration and enforcement of pledges. Pledge laws may impose significant notarization fees on pledges. Company laws do not ensure adequate corporate governance or protect shareholders' rights. Laws may contain inconsistencies or ambiguities concerning, inter alia, the scope of reorganization proceedings and/or the priority of secured creditors in bankruptcy.
3 New or amended legislation has recently been enacted in at least two of the three areas that were the focus of this survey--pledge, bankruptcy or company law--but could benefit from further refinement and clarification. Legal rules permit a non-possessory pledge over most types of movable assets. However, the mechanisms for registration of the security interest are still

rudimentary and do not provide parties with adequate protection. There is scope for enforcement of pledges without court assistance. Company laws may contain limited provisions for corporate governance and the protection of shareholders' rights. Bankruptcy legislation contains provisions for both reorganization and liquidation but may place claims of other creditors in priority to those of secured creditors in liquidation.

4 Comprehensive legislation exists in a least two of the three areas of commercial law that were the focus of this survey--pledge, bankruptcy and company law. Pledge law allows parties to take non-possessory pledges in a wide variety of movable property and contains mechanisms for enforcement of pledges without court assistance. The legal infrastructure, however, is not fully developed to include a centralized or comprehensive mechanism for registering pledges. Company laws contain provisions for corporate governance and the protection of shareholders' rights. Director and officer duties are defined. Bankruptcy law includes detailed provisions for reorganization and liquidation. Liquidators possess a wide variety of powers to deal with the property and affairs of a bankrupt.

5 Comprehensive legislation exists in all three areas of commercial law--pledge, bankruptcy and company law. Legal rules closely approach those more developed countries. These legal systems have a uniform (i.e., centralized registration) system for the taking and enforcement of a security interest in movable assets and also provide for adequate corporate governance and protect shareholders' rights. In particular the rights of minority shareholders are protected in the event of the acquisition by third parties of less than all of the shares of a widely held company. Bankruptcy law provides in a comprehensive manner for both reorganization and liquidation. Liquidators possess a wide variety of powers and duties to deal with the property and affairs of a bankrupt, including wide powers of investigation of pre-bankruptcy transactions carried out by the debtor. There are specialized courts that handle bankruptcy proceedings. Liquidators must possess certain minimum qualifications.

(b) Effectiveness

1 Commercial legal rules are usually very unclear and sometimes contradictory. The administration and judicial support for the law is rudimentary. The cost of transactions, such as creating a pledge over a movable asset is prohibitive so as to render a potentially extensive law ineffective. There are no meaningful procedures in place in order to make commercial laws fully operational and enforceable. There are significant disincentives for creditors to seek the commencement of bankruptcy proceedings in respect of insolvent debtors.

2 Commercial legal rules are generally unclear and sometimes contradictory. There are few, if any meaningful procedures in place in order to make commercial laws operational and enforceable.

3 While commercial legal rules are reasonably clear, administration or judicial support of the law is often inadequate or inconsistent so as to create a degree of uncertainty (e.g., substantial discretion in the administration of laws, few up-to-date registries for pledges).

4 Commercial laws are reasonably clear and administrative and judicial support of the law is reasonably adequate. Specialized courts, administrative bodies or independent agencies may exist for the liquidation of insolvent companies, the registration of publicly traded shares or the registration of pledges.

5 Commercial laws are clear and readily ascertainable. Commercial law is well supported administratively and judicially, particularly regarding the efficient functioning of courts, liquidation proceedings, the registration of shares and the orderly and timely registration of security interests.

Environmental Policy Reform. The environmental policy reform indicator is drawn from EBRD (November 1997). Four components go into it (see table below). The first is the degree of adherence to six key international environmental treaties: the Convention on the Wetlands of International Importance; the Convention on International Trade in Endangered Species of Wild Fauna and Flora; the Montreal Protocol for the control of CFC emissions; the Convention on Climate Change; the Convention on Biodiversity; and the Convention on Environmental Impact in a Transboundary Context. Countries are put into three groups on the basis of their progress towards signing and ratifying these treaties.

The second component attempts to measure progress in air and water ambient and emission (effluent) standards. Three levels of progress are identified: (1) the maximum permissible concentrations (MPC) system in place, broadly based on the former Soviet system; (2) a new system is being introduced, either as an evolution of MPC or in order to meet EU requirements; and (3) essentially new standards system is in place, often following EU requirements.

The third component attempts to measure progress in preparing and implementing national environmental action plans (NEAPs). Countries either have a NEAP planned or under preparation; or they have a NEAP prepared and under implementation.

Finally, the fourth component tries to assess the extent to which environmental financial mechanisms are used. From an EBRD questionnaire sent to the authorities in charge of the environment in each of the countries, information on four instruments were compiled: (1) existence of an environmental fund for channeling the money collected in fees and fines to environmental investments; (2) provision of taxes/other penalties or financial incentives for energy and resource efficiency; (3) waste and pollution reduction; (4) the use of clean technologies. Countries were grouped in two: those in which three or more financial instruments are in place; and those with less than three instruments in place.

B. Freedom House's Rating Scheme on Economic Policy

In its *Nations in Transit 1998*, Freedom House measures progress towards economic reforms by assessing a series of questions in three broad categories: (1) privatization; (2) macroeconomic policy; and (3) microeconomic policy. Progress towards each category is rated on a seven-category scale, 1 representing the most advanced and 7 the least advanced, and the three are averaged. To conform with the EBRD scheme, we convert the 1-to-7 scale to 1-to-5, with 5 representing the most advanced.

Privatization
(1) What percentage of the GDP comes from private ownership? What percentage of the labor forces is employed in the private sector? How large is the informal sector of the economy?
(2) What major privatization legislation has been passed? What were its substantive features?
(3) What proportion of agriculture, housing and land, industry, and business and services is in

private hands?
(4) What has been the extent of insider (management, labor, and nomenklatura) participation in the privatization process? What explicit and implicit preferences have been awarded to insiders?
5. How much public awareness of and support for privatization has there been? What is the nature of support and opposition to privatization by major interest groups?

Macroeconomic Policy
(1) Has the taxation system been reformed? (What areas have and have not been overhauled? To what degree are taxpayers complying? Is tax compliance difficult to achieve? Has the level of revenues increased? Is the revenue-collection body overburdened? What is the overall tax burden?)
(2) Does fiscal policy encourage private savings, investment and earnings? (Has there been any reform/alteration of revenue and budget policies? How large are budget deficits and overall debt? Is the financing of the social insurance/pension system sustainable? What proportion of the budget is taken up by subsidies to firms and individuals?)
(3) Has there been banking reform? (Is the central bank independent? What are its responsibilities? Is it effective in setting and/or implementing monetary policy? What is the actual state of the private banking sector? Does it conform to international standards? Are depositors protected?)
(4) How sound is the national currency? (Is the value of the currency fixed or does it float? How convertible is the currency? How large are the hard currency reserves? Has exchange rate policy been stable and predictable?)
(5) Is there a functioning capital market infrastructure? (Are there existing or planned commodities, bond and stock markets? What are the mechanisms for investment and lending? What government bodies have authority to regulate capital markets?)
Microeconomic Policy
(1) Are property rights guaranteed? (Are there both formal and de facto protections of private real estate and intellectual property? Is there a land registry with the authority and capability to ensure accurate recording of who owns what? What are the procedures for expropriation, including measures for compensation and challenge? Have any seizures taken place?)
(2) To what extent have prices been liberalized? What subsidies remain?
(3) Is it possible to own and operate a business? (Has there been legislation regarding the formation, dissolution and transfer of businesses, and is the law respected? Do there exist overly cumbersome bureaucratic hurdles that effectively hinder the ability to own and dispose of a business? Are citizens given access to information on commercial law? Is the law applied fairly? Does regulation (or licensing requirements) impose significant costs on business and consumers? Do they create significant barriers to entry and seriously hamper competition?)
(4) Are courts effective, transparent, efficient, and quick in reaching decisions on property and contract disputes? What alternative mechanisms for adjudicating disputes exist?
(5) Is business competition encouraged? (Are monopolistic practices limited in law and in practice? If so, how? To what degree is "insider" dealing a hindrance to open competition? Are government procurement policies open and unbiased?)
(6) To what extent has international trade been liberalized? (To what degree has there been simplification/overhaul of customs and tariff procedures, and are these applied fairly? What informal trade barriers exist?)
(7) To what degree has foreign investment and capital flow been encouraged or constrained?
(8) Has there been reform of the energy sector? (To what degree has the energy sector been

restructured? Is the energy sector more varied, and is it open to private competition? Is the country overly dependent on one or two other countries for energy [including whether exported fuels must pass through one or more countries to reach markets]?)

C. Democratic Freedoms: Elaboration of Freedom House's Rating Scheme of Political Rights and Civil Liberties

Freedom House annually rates political rights and civil liberties separately on a seven-category scale, 1 representing the most free and 7 the least free. The 1997-1998 Survey included 191 countries and/or territories. The 1-to-7 rating is derived by country teams awarding from 0 to 4 raw points per checklist item (shown below). The highest possible score for political rights is 32 points, based on up to 4 points for each of eight questions. The highest possible score for civil liberties is 52 points, based on up to 4 points for each of thirteen questions. Under the methodology, raw points correspond to category numbers as follows:

<u>Political Rights category number</u>	<u>Raw points</u>
1	28-32
2	23-27
3	19-22
4	14-18
5	10-13
6	5-9
7	0-4

<u>Civil Liberties category number</u>	<u>Raw points</u>
1	45-52
2	38-44
3	30-37
4	23-29
5	15-22
6	8-14
7	0-7

Political Rights checklist

1. Is the head of state and/or head of government or other chief authority elected through free and fair elections?
2. Are the legislative representatives elected through free and fair elections?

3. Are there fair electoral laws, equal campaigning opportunities, fair polling and honest tabulation of ballots?
4. Are the voters able to endow their freely elected representatives with real power?
5. Do the people have the right to organize in different political parties or other competitive political groupings of their choice, and is the system open to the rise and fall of these competing parties or groupings?
6. Is there a significant opposition vote, de facto opposition power, and a realistic possibility for the opposition to increase its support or gain power through elections?
7. Are the people free from domination by the military, foreign powers, totalitarian parties, religious hierarchies, economic oligarchies or any other powerful group?
8. Do cultural, ethnic, religious and other minority groups have reasonable self-determination, self-government, autonomy or participation through informal consensus in the decision-making process?

Civil Liberties checklist

1. Are there free and independent media, literature and other cultural expressions? (Note: In cases where the media are state-controlled but offer pluralistic points of view, the Survey gives the system credit).
2. Is there open public discussion and free private discussion?
3. Is there freedom of assembly and demonstration?
4. Is there freedom of political or quasi-political organization? (Note: This includes political parties, civic associations, ad hoc groups and so forth.)
5. Are citizens equal under the law, with access to an independent, nondiscriminatory judiciary, and are they respected by the security forces?
6. Is there protection from political terror, and from unjustified imprisonment, exile or torture, whether by groups that support or oppose the system, and freedom from war or insurgency situations? (Note: Freedom from war and insurgency situations enhances the liberties in a free society, but the absence of wars and insurgencies does not in itself make an unfree society free.)
7. Are there free trade unions and peasant organizations or equivalents, and is there effective collective bargaining?
8. Are there free professional and other private organizations?
9. Are there free businesses or cooperatives?
10. Are there free religious institutions and free private and public religious expressions?
11. Are there personal social freedoms, which include such aspects as gender equality, property rights, freedom of movement, choice of residence, and choice of marriage and size of family?
12. Is there equality of opportunity, which includes freedom from exploitation by or dependency on landlords, employers, union leaders, bureaucrats or any other type of denigrating obstacle to a share of legitimate economic gains?
13. Is there freedom from extreme government indifference and corruption?

Political Rights

1 Rating. Generally speaking, places rated 1 come closest to the ideals suggested by the checklist questions, beginning with free and fair elections. Those elected rule. There are competitive parties

or other competitive political groupings, and the opposition has an important role and power. These entities have self-determination or an extremely high degree of autonomy. Usually, those rated 1 have self-determination for minority groups or their participation in government through informal consensus. With the exception of such entities as tiny island countries, these countries and territories have decentralized political power and free sub-national elections.

2 Rating. Such factors as gross political corruption, violence, political discrimination against minorities, and foreign or military influence on politics may be present, and weaken the quality of democracy.

3,4, and 5 Ratings. The same factors that weaken freedom in category 2 may also undermine political rights in categories 3,4, and 5. Other damaging conditions may be at work as well, including civil war, very strong military involvement in politics, lingering royal power, unfair elections and one-party dominance. However, states and territories in these categories may still have some elements of political rights such as the freedom to organize nongovernmental parties and quasi-political groups, reasonably free referenda, or other significant means of popular influence on government.

6 Rating. Typically, such states have systems ruled by military juntas, one-party dictatorships, religious hierarchies and autocrats. These regimes may allow only some minimal manifestation of political rights such as competitive local elections or some degree of representation or autonomy for minorities. Category 6 also contains some countries in the early or aborted stages of democratic transition. A few states in Category 6 are traditional monarchies that mitigate their relative lack of political rights through the use of consultation with their subjects, toleration of political discussion, and acceptance of petitions from the ruled.

7 Rating. This includes places where political rights are absent or virtually nonexistent due to the extremely oppressive nature of the regime or extreme oppression in combination with civil war. A country or territory may also join this category when extreme violence and warlordism dominate the people in the absence of an authoritative, functioning central government.

Civil Liberties

1 Rating. This includes countries and territories that generally have the highest levels of freedoms and opportunities for the individual. Places in this category may still have problems in civil liberties, but they lose partial credit in only a limited number of areas.

2 Rating. Places in this category, while not as free as those in 1, are still relatively high on the scale. These countries have deficiencies in several aspects of civil liberties, but still receive most available credit.

3, 4, and 5 Ratings. Places in these categories range from ones that receive at least partial credit on virtually all checklist questions to those that have a mixture of good civil liberties scores in some areas and zero or partial credit in others. As one moves down the scale below category 2, the level of oppression increases, especially in the areas of censorship, political terror and the prevention of free association. There are also many cases in which groups opposed to the state carry out political terror that undermines other freedoms. That means that a poor rating for a country is not necessarily a comment on the intentions of the government. The rating may simply reflect the real restrictions on liberty which can be caused by non-governmental terror.

6 Rating. Typically, at category 6 in civil liberties, countries and territories have few partial rights. For example, a country might have some religious freedom, some personal social freedoms, some highly restricted private business activity, and relatively free private discussion. In general, people in these states and territories experience severely restricted expression and association. There are almost always political prisoners and other manifestations of political terror.

7 Rating. At category 7, countries and territories have virtually no freedom. An overwhelming and justified fear of repression characterizes the society.

D. Democratic Freedoms Disaggregated: Elaboration of Freedom House's Rating Scheme in its Nations in Transit 1998

In its *Nations in Transit 1998*, Freedom House measures progress towards democratic freedoms by assessing a series of questions in six categories: (1) political process; (2) civil society; (3) independent media; (4) governance and public administration; (5) rule of law; and (6) corruption. Progress towards each category is rated on a seven-category scale, 1 representing the most advanced and 7 the least advanced.

Political process
(1) When did national legislative elections occur? Were they free and fair? How were they judged by domestic and international election monitoring organizations? Who composes the government?
(2) When did presidential elections occur? Were they free and fair?
(3) Is the electoral system multiparty-based? Are there at least two viable political parties functioning at all levels of government?
(4) How many parties have been legalized? Are any particular parties illegal?
(5) What proportion of the population belongs to political parties?
(6) What has been the trend of voter turnout at the municipal, provincial and national levels in recent years?

Civil Society
(1) How many nongovernmental organizations have come into existence since 1988? How many charitable/nonprofit organizations? How many were there last year? Are they financially viable?
(2) What forms of interest group participation in politics are legal? Which interest groups are active politically?
(3) Are there free trade unions? How many workers belong to these unions? Is the number of workers belonging to trade unions growing or decreasing?
(4) What is the numerical/proportional membership of farmers' groups, small business associations, etc?

Independent Media
(1) Are there legal protections for press freedoms?
(2) Are there legal penalties for libeling officials? Are there legal penalties for "irresponsible" journalism? Have these laws been enforced to harass journalists?
(3) What proportion of the media is privatized? What are the major private newspapers, television stations, and radio stations?
(4) Are the private media financially viable?
(5) Are the media editorially independent? Are the media's news gathering functions affected by interference from government or private owners?
(6) Is the distribution system for newspapers privately or governmentally controlled?
(7) What proportion of the population is connected to the Internet? Are there any restrictions on Internet access to private citizens?
(8) What has been the trend in press freedom as measured by Freedom House's *Survey of Press Freedom*?

Governance and Public Administration
(1) Is the legislature the effective rule-making institution?
(2) Is substantial power decentralized to subnational levels of government? What specific authority do subnational levels have?
(3) Are subnational officials chosen in free and fair elections?
(4) Do the executive and legislative bodies operate openly and with transparency? Is draft legislation easily accessible to the media and the public?
(5) Do municipal governments have sufficient revenues to carry out their duties? Do municipal governments have control of their own local budgets? Do they raise revenues autonomously or from the central state budget?
(6) Do the elected local leaders and local civil servants know how to manage municipal governments effectively?
(7) When did the constitutional/legislative changes on local power come into effect? Has there been a reform of the civil service code/system? Are local civil servants employees of the local or central government?

Rule of Law
(1) Is there a post-Communist constitution? How does the judicial system interpret and enforce the constitution? Are there specific examples of judicial enforcement of the constitution in the last year?
(2) Does the constitutional framework provide for human rights? Do the human rights include business and property rights?
(3) Has there been basic reform of the criminal code/criminal law? Who authorizes searches and issues warrants? Are suspects and prisoners beaten or abused? Are there excessive delays in the criminal justice system?
(4) Do most judges rule fairly and impartially? Do many remain from the Communist era?
(5) Are the courts free of political control and influence? Are the courts linked directly to the Ministry of Justice or any other executive body?
(6) What proportion of lawyers is in private practice? How does this compare with the previous year?

(7) Does the state provide public defenders?
(8) Are there effective antibias/discrimination laws, including protection of ethnic minorities?

Corruption

(1) What is the magnitude of official corruption in the civil service? Must an average citizen pay a bribe to a bureaucrat in order to receive a service? What services are subject to bribe requests--for example, university entrance, hospital admission, telephone installation, obtaining a license to operate a business, applying for a passport or other official documents? What is the average salary of civil servants at various levels?
(2) Do top policy makers (the president, ministers, vice-ministers, top court justices, and heads of agencies and commissions) have direct ties to businesses? How strong are such connections and what kinds of businesses are these?
(3) Do laws requiring financial disclosure and disallowing conflict of interest exist? Have publicized anticorruption cases been pursued? To what conclusion?
(4) What major anticorruption initiatives have been implemented? How often are anticorruption laws and decrees adopted?
(5) How do major corruption-ranking organizations like Transparency International rate this country?

APPENDIX II: TRANSITION PATHS (in graphs)

(1) Macroeconomic performance
- (a) Official economy share of 1989 GDP
- (b) Unofficial economy share of official GDP
- (c) Export volume

(2) Market structure
- (a) (Official) private sector share of GDP
- (b) New start firms
- (c) SMEs
- (d) Trade: composition & direction
  1. Composition of exports
  2. Composition of imports
  3. Intra-industry trade
  4. Intra-industry trade growth in CEE
  5. Exports to EU
  6. Exports to FSU
- (e) Corruption
  1. Comparisons worldwide
  2. Within the transition economies

(3) Democratization
- (a) Democratic freedoms
- (b) Perceptions:
  1. Old vs. new regimes
  2. Return to communism?

(4) Social conditions
- (a) Income distributed
- (b) Poverty rates
- (c) Life expectancy

(5) Effects from the global economic crisis
- (a) Trade links to Russia
- (b) Contagion prospects
  1. Short-term debt to reserves
  2. Macroeconomic imbalances

Monitoring Country Progress
In Central and Eastern Europe &
The New Independent States

APPENDIX II:
Transition Paths

USAID/ENI
Bureau for Europe & The New Independent States
U.S. Agency for International Development

October 1998

Appendix II: Transition Paths

Contents

APPENDIX II
TRANSITION PATHS

Much of the available evidence, underscored by widely different initial conditions among the transition countries, suggest that there are distinct transition paths emerging. The best spin on this may be that the laggards, by and large the NIS, may just take much longer and incur greater costs to get to where the Northern Tier CEE leaders are heading. It may be primarily time, in other words, that separates the Northern Tier CEE leaders and much of the rest. The more troubling possibility in some countries is the evolution of transition paths that may not be leading to democratic societies and competitive market economies characterized by a broad-based sharing of the gains. Can the "crony capitalism" of Russia and/or the autocratic rule in much of the Central Asian Republics transform into and integrate with the Western-oriented market democracies?

This appendix is a preliminary sketch of some of the dimensions of the emerging transition paths among the transition subregions. Five broad dimensions are highlighted: (1) macroeconomic performance; (2) market structure: (3) democratization; (4) social conditions; and (5) effects from the global economic crisis.

1. Macroeconomic performance. Official income trends between the Northern Tier CEE countries and the NIS (Figure 1.a.) continue to diverge. Real GDP in the Northern Tier countries now exceeds pre-transition income levels on average. For the NIS, 1998 real GDP is fifty-five percent of pre-transition (1989) income, and falling. The mirror image of the divergence in real official incomes is the trend in unofficial incomes (Figure 1.b.). Estimates from Johnson, Kaufmann, and Shleifer (1997) suggest a growing unofficial economy in the NIS as real GDP continues to fall. In contrast, the unofficial economy as a proportion of real GDP in the CEE countries has been falling since 1993. In 1995, the unofficial economy as a share of real GDP was more than twice the size in the NIS than in CEE.

Trends in the volume of exports highlight further still the divergence in macroeconomic performance between the NIS and CEE (Figure 1.c.). Exports in the NIS fell much more in the early transition years than did exports in CEE. While export growth has been positive on average in both subregions since 1992, the expansion has been much greater in CEE.

2. Market structure. There has been an impressive growth of the private sector share in both subregions (Figure 2.a.). The subregional averages in 1997 are not much different: the private sector consists of sixty-five percent of the economies in CEE compared to fifty-nine percent in the NIS. (Russia's high private sector share of seventy percent of GDP pulls up the population-weighted NIS average substantially.) Anecdotal evidence and casual observations tell us, however, that the characteristics of the private sectors vary widely between countries. Some private sectors have relatively competitive markets; others are dominated by oligopolists with excessive market power. Similarly, some provide for a relatively broad-based sharing of the gains and costs; others provide for the privatization of the gains for a small percentage of the population, and the socialization of the costs for the majority.

The proportion of new start firms in the private sector (Figure 2.b.) gives a rough proxy of the degree of market competition and economic efficiency. New start firms tend to have much better corporate governance than do privatized and state-owned firms, and tend to be more responsive to consumers and to changing market conditions. In 1995, more than three-fourths of the private sector in the Northern Tier CEE countries, by one estimate, consisted of new start firms. In contrast, new starts consisted of roughly fifty percent of the private sector in the NIS.

Measuring the size of the small and medium enterprises (SMEs) gets at the same concepts of market competition and economic efficiency. An estimate of the scope of SMEs in the early transition years reveals large differences between CEE, the NIS, and Western economies. In 1993, only eleven percent of the labor force in the NIS was employed in SMEs. In CEE, it was twenty-seven percent, more than twice the NIS average. In the U.S. and the EU, it was much higher still. More recent estimates of the magnitude of the SME sectors are needed.

Significant differences in the structure and direction of trade exist between the transition subregions (Figures 2.d.1. through 2.d.6.). Differences in economies' comparative advantages and in trade partners provide some indication of differences in the competitiveness of these economies and future economic prospects. The CEE countries export a large proportion of manufactures (over forty percent in 1995) (Figure 2.d.1.). Most exports from the NIS, in contrast are raw materials and/or fuel (forty-three percent in 1995), and only nine percent are manufactures. The structure of imports are quite similar between the subregions (Figure 2.d.2.). In particular, manufactured imports are high throughout the transition countries. Part of this is likely because virtually all of these countries are in need of capital goods imports, different transition stages notwithstanding.

The volume of intra-industry trade varies widely among the countries (Figure 2.d.3.). In general, the more advanced and sophisticated is the structure of the economy, the greater is the intra-industry trade with other countries (and the greater are the returns from trade). The EBRD reports significantly higher intra-industry in the Northern Tier CEE countries, and very little by comparison in the NIS. The volume of intra-industry trade in the Southern Tier countries is somewhere in between. The growth of intra-industry trade in CEE with the EU has been impressive (Figure 2.d.4.) and suggests significant economic restructuring. The volume of intra-industry trade with the EU among these countries is not yet as great as exists, for example, in Spain, but these countries may be catching up in this regard. Intra-industry trade in the NIS has grown very little.

The re-orientation of trade partners has been substantial in CEE, particularly in the Northern Tier countries. In 1996, sixty percent of Northern Tier exports went to the EU (Figure 2.d.5.). In contrast, only twelve percent of NIS exports (excluding Russia) went to the EU in 1996. Most of the exports from the NIS still remain within the former Soviet Union (Figure 2.d.6.). The NIS less Russia had fifty-seven percent of its exports stay within the former Soviet Union in 1996. Nevertheless, this is a significant reduction from around eighty-five percent in 1990. Roughly thirty percent of CEE exports went to the Soviet Union in 1990, and only thirteen percent went to the former Soviet Union in 1996.

Corruption lubricates and pervades economic activity in the NIS. In fact, a worldwide survey cited by the World Bank in its World Development Report 1997 suggests that businesses are most adversely affected by corruption in the NIS, followed by those in Sub-Saharan Africa, which in turn is followed by those in Central and Eastern Europe (Figure 2.e.1.). Freedom House scores corruption among the transition countries on four levels (Figure 2.e.2.). Eight of the ten countries where corruption is highest are NIS. The seven countries that have the lowest corruption are all found in the Northern Tier CEE.

3. Democratization. Extraordinary gains in democratic freedoms were made in the early transition years throughout the transition countries (Figure 3.a.). By 1993, several Northern Tier countries had achieved democratic freedoms roughly comparable to that found in many Western democracies. By 1997, seven Northern Tier countries had achieved such a threshold. Many Southern Tier CEE countries are approaching it. In the NIS, by contrast, the early gains did not translate into continued increases in democratic freedom. In fact, since 1991, backsliding on balance in democratic reforms has occurred in eight of the twelve NIS.

Popular perceptions regarding current political regimes and the old (communist) regimes vary widely between CEE and the NIS (Figure 3.b.1). In 1992 and 1993, the majority of persons surveyed in CEE viewed the current (reformist) regimes favorably. This had grown to sixty-five percent by 1995-1996. During that period, the proportion of people in the CEE who had a favorable view of the former communist regimes decreased from forty-four percent in 1992-1993 to forty percent in 1995-1996. In 1992-1993, the majority of Russians surveyed viewed the old communist regime favorably, while only fourteen percent viewed the current reformist regime in a positive light. The reactions among Russians in 1995-1996 were largely a mirror image of those in CEE in that period. Sixty percent of the respondents looked back on the communist political regime in a favorable way (an increase from 1992-1993), while close to forty percent received the current regime favorably.

This is not the same thing as wishing for a return to the communist days (Figure 3.b.2.). In both regions, much less than a majority want that to happen. Still, the wish is much higher in Russia in 1996 (thirty-five percent of respondents), than it is CEE (sixteen percent in 1995). It is probably higher still today in Russia.

4. Social conditions. Social conditions diverge widely between the transition subregions. Income inequality has increased significantly in most all the transition countries (Figure 4.a.). Far and away, however, the greatest increase has been in the NIS, where levels of income inequality in some countries (such as Russia and Kyrgyzstan, and possibly Ukraine) are now comparable to those found in Latin America and Sub-Saharan Africa. Prior to the collapse of communism, official income (at any rate) was more equally distributed in most of these countries (CEE and NIS) than in the EU. Today, the inequality levels in the Northern Tier CEE countries may be slightly above those in the EU.

Poverty rates have similarly increased dramatically (Figure 4.b.). Again, however, the increases have been much more dramatic in the NIS. By 1995, by one conservative count, one in two persons in the NIS were poor. In 1987-1988, the NIS poverty rate was only four percent. The

Northern Tier poverty rate increased from three percent in 1987-1988 to eleven percent in 1993-1995. The Southern Tier poverty rate increased from five percent to twenty-four percent.

Trends in education are diverging (Figure 4.c.). In the Northern Tier, secondary school enrollment has increased from 1990 to 1995, and is now at a level (at ninety-two percent) slightly above that found in the EU. Secondary school enrollment, however, has been falling in the NIS as well as in the Southern Tier CEE countries.

5. Effects from the global economic crisis. The global economic crisis (of which the Russian crisis is a part) has so far served to further widen the gap between the Northern Tier leaders and most of the rest. The Northern Tier countries have so far fared quite well from the crisis, and this reflects a solid foundation of reforms, and substantial and growing ties to Western Europe. To some extent, Lithuania and Latvia may be exceptions since they remain closely linked to Russia.

Perhaps there are two types of adverse spillover effects to look for. One type is the more tangible and more predictable effects that stem from economic (trade and finance) links with countries in crisis. The other is the emerging market contagion effects.

Many countries of the former Soviet Union in particular are vulnerable through either or both effects. Trade links to Russia remain strong for many of these countries (Figure 5.a.). Exports and economic growth will likely be significantly reduced in some countries as a result. Perhaps more than fifty percent of exports from Moldova and Belarus go to Russia; for Kazakhstan and Ukraine, it's closer to forty percent; Armenia, Lithuania, and Latvia, twenty to thirty percent. Except for the Baltics, trade with Russia in CEE is insignificant (five percent of exports on average go to Russia). Forty percent of NIS exports go to Russia.

Some countries, most notably Latvia, have banks with heavy exposure to Russian assets. This could precipitate a banking crisis. Individual banks from other countries (the Czech Republic, Lithuania, and Ukraine) are also apparently exposed.

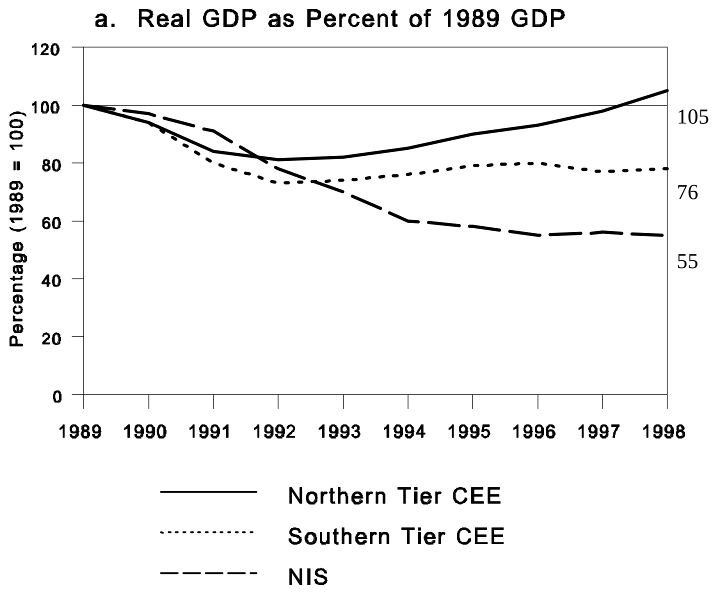
Then there is the danger of being tagged by international investors as being vulnerable to financial crisis, thus helping to realize it (contagion). A salient leading indicator here is the ratio of short-term debt to reserves (Figure 5.b.). If reserves can't cover short-term debt (that is, if this ratio is greater than one), it needs to be a concern. Four of the five Asian emerging market countries that are in crisis had a ratio higher than one prior to crisis; on average in 1997 for the five countries, close to a ratio of two. Russia had a ratio closer to 2.5 over the months leading to crisis. From the available data, as of end-year 1997, Russia looks to be an outlier in the transition region on this indicator. Slovakia comes closest (0.7). Short-term debt to reserves may have been around 0.5 at the end of 1997 for Ukraine, though it may be that the reserves are overstated since much of them were largely in Russian government paper.

A more relevant indicator for the transition region for this purpose may be macroeconomic imbalances (fiscal and current account deficits) (Figure 5.c.). The greater are the imbalances, the lower is the investor confidence, and with that, the higher the cost of borrowing, the lower the availability of financing, the greater the pressures on currencies to devalue, and so on. The adverse effects of high "twin deficits" are exacerbated when debt service is likewise high.

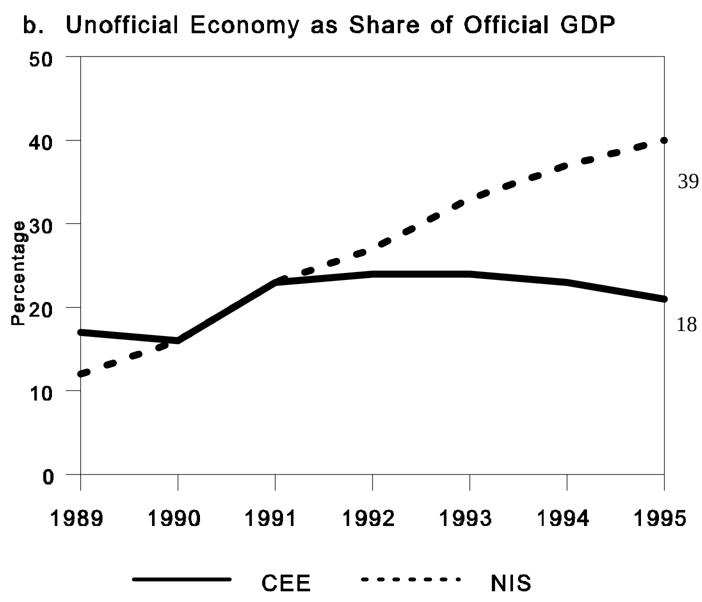
Countries that may be vulnerable on these scores include Moldova, Slovakia, Romania, Lithuania, Croatia, and possibly Ukraine. Some of the other NIS have very high imbalances, though are probably less vulnerable given relatively little exposure to international capital markets.

Transition Paths

1. Macroeconomic performance



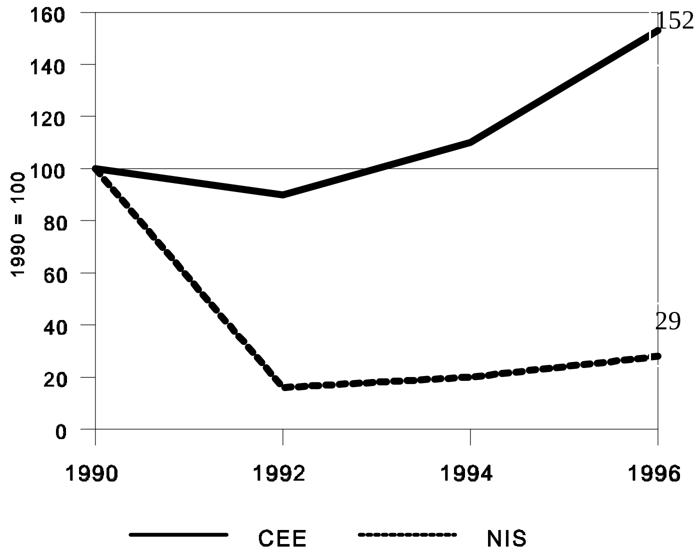
source: EBRD, *Transition Report 1998* (November, *forthcoming* and previous editions).



source: S. Johnson, D. Kaufmann, and A. Shliefer, "Politics and Entrepreneurship in Transition Economies," Working Paper Series, No. 57, The William Davidson Institute, University of Michigan (1997).

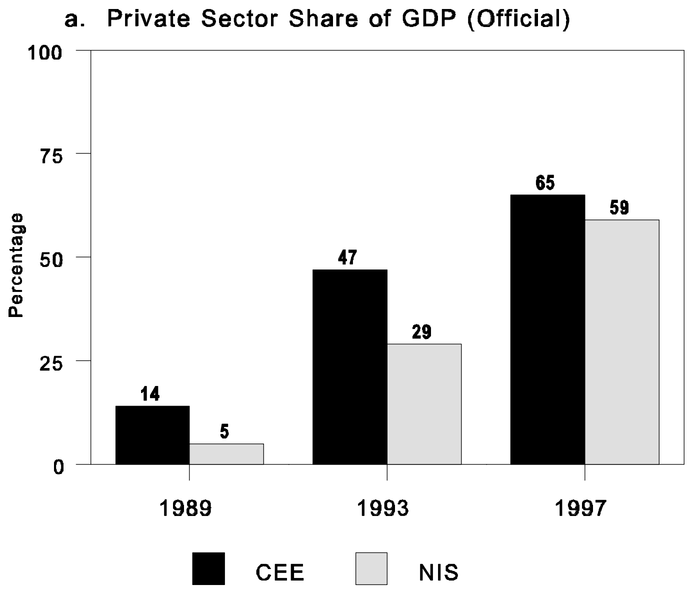
1. Macroeconomic Performance

c. Export Volume as a Percentage of 1990 Exports

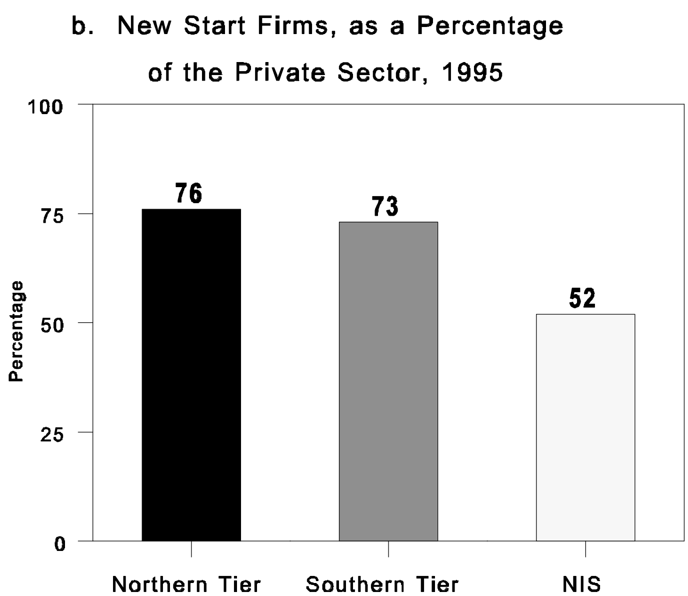


source: O. Havrylysyhn and H. Al-Atrash, "Opening Up and Geographic Diversification of Trade in Transition Economies," *IMF Working Paper*, WP/98/22, February 1998.

2. Market Structure



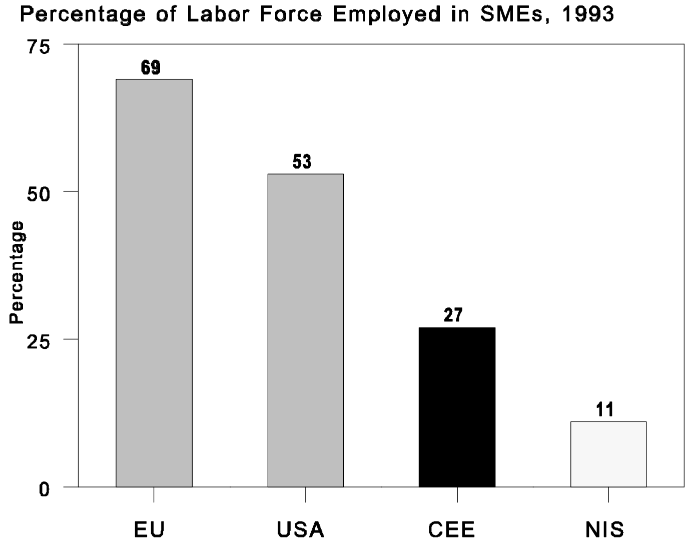
source: EBRD, *Transition Report*, various years.



source: Calculated from S. Johnson, D. Kaufmann, and A. Shliefer, “Politics and Entrepreneurship in Transition Economies,” Working Paper Series, No. 57, The William Davidson Institute, University of Michigan (1997); EBRD, *Transition Report*, 1995.

2. Market Structure

c. Small and Medium Enterprises (SMEs)

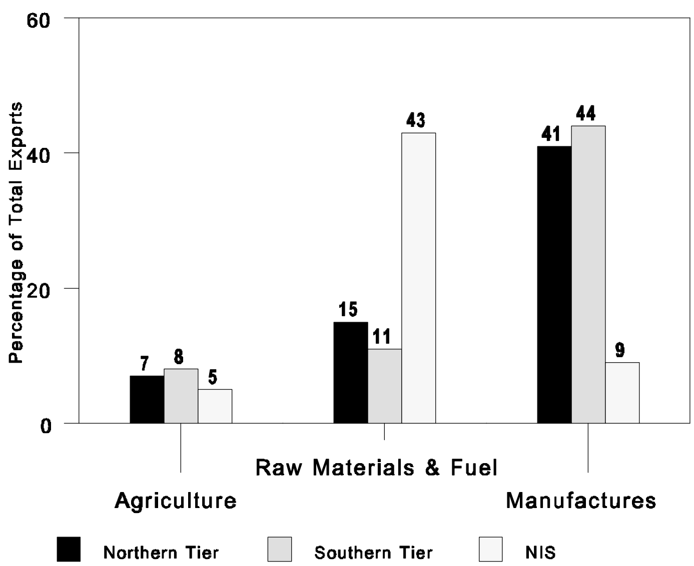


source: EBRD, *Transition Report*, 1995.

---

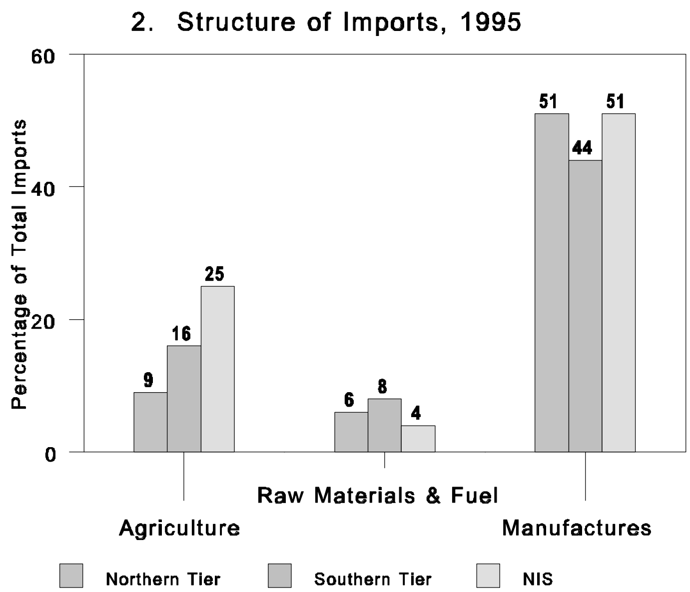
2. Market Structure
   d. Trade: Composition & Direction

1. Structure of Exports, 1995



note: Chemicals and intermediate goods exports are excluded, thus making the three items shown fall short of adding up to 100 percent.
source: EBRD *Transition Report*, 1997.

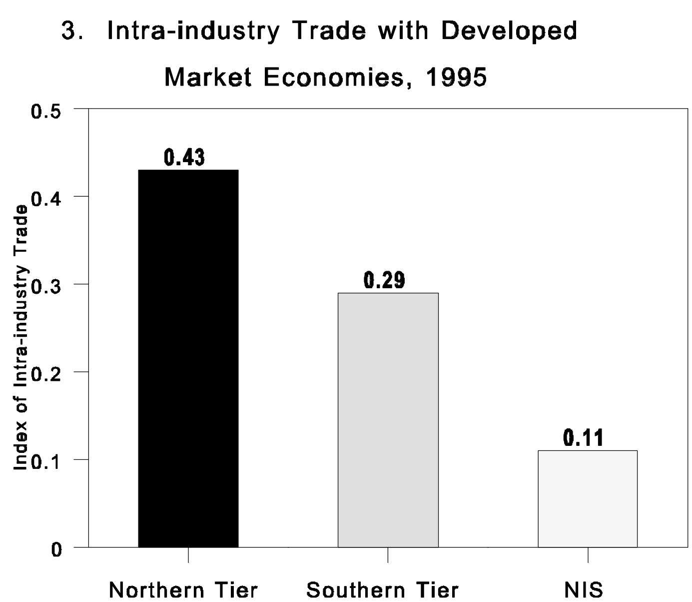
2. Market Structure
   d. Trade: Composition & Direction



note: Chemicals and intermediate goods imports are excluded, thus making the three items shown fall short of adding up to 100 percent.
source: EBRD *Transition Report*, 1997.

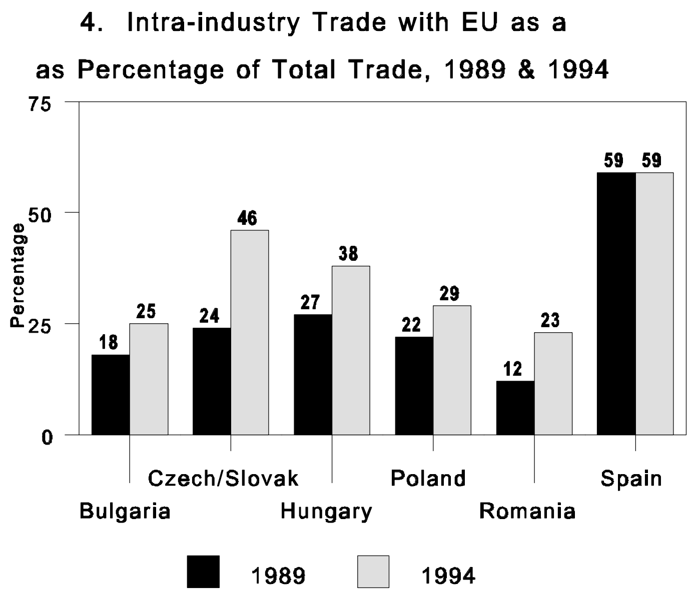
---

2. Market Structure
   d. Trade: Composition & Direction

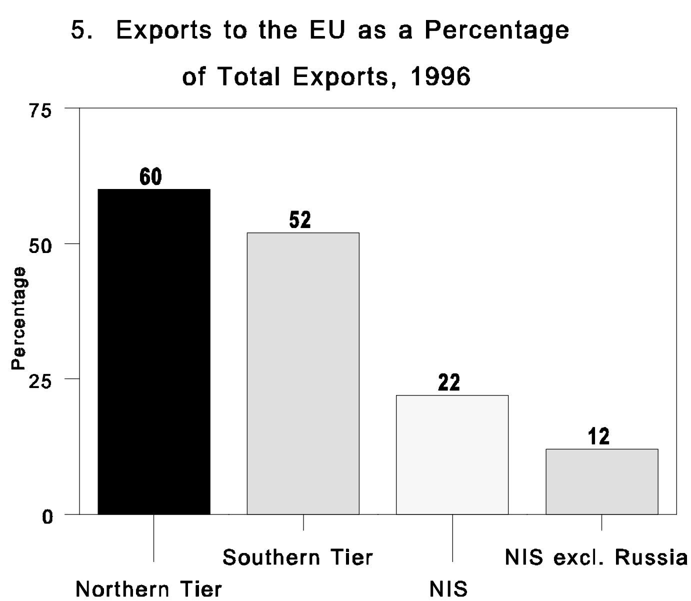


source: EBRD, *Transition Report*, 1997.

2. Market Structure
   d. Trade: Composition & Direction



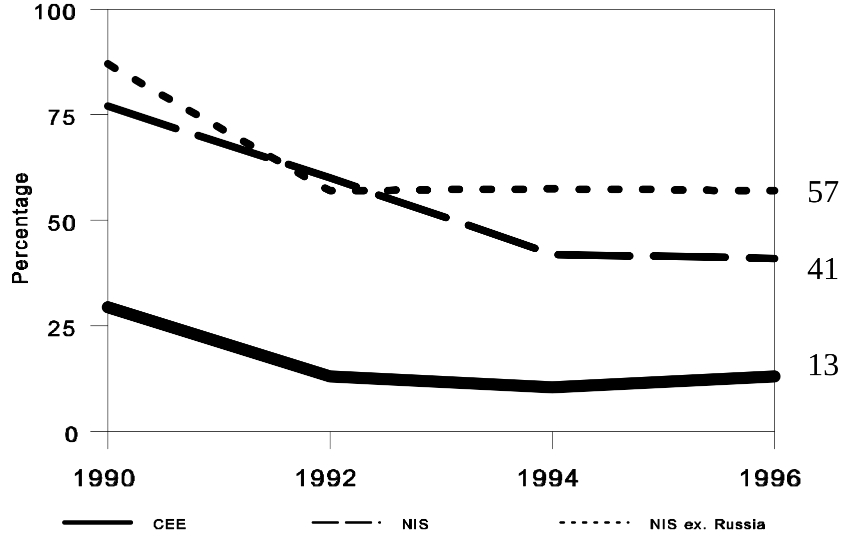
source: P. Brenton & D. Gros, "Trade Reorientation and Recovery in Transition Economies," *Oxford Review of Economic Policy*, volume 13, no. 2 (1997), pp. 65-76.



source: O. Havrylysyhn and H. Al-Atrash, "Opening Up and Geographic Diversification of Trade in Transition Economies," *IMF Working Paper*, WP/98/22, February 1998.

2. Market Structure
   d. Trade: Composition & Direction

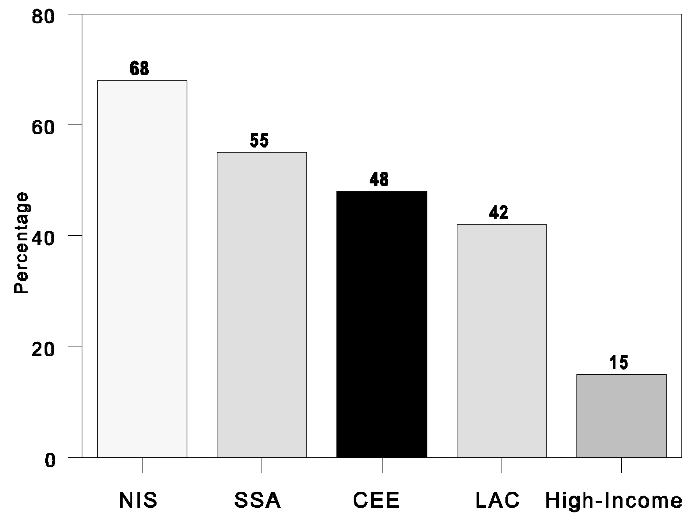
6. Exports to the Former Soviet Union as a Percentage of Total Exports, 1990-96



source: O. Havrylysyhn and H. Al-Atrash, “Opening Up and Geographic Diversification of Trade in Transition Economies,” *IMF Working Paper*, WP/98/22, February 1998.

2. Market Structure
   e. Corruption

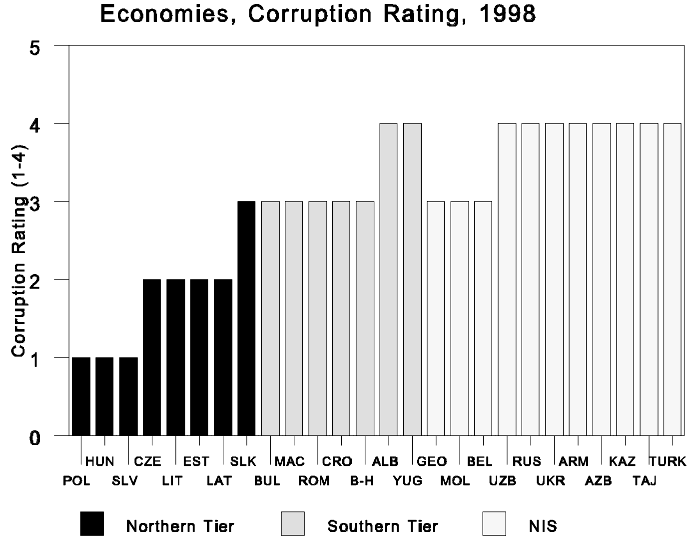
1. Worldwide Comparison: Percentage of Survey Respondents Dissatisfied with Level of Corruption, 1996



note: Survey respondents were from over 3,600 business firms worldwide. SSA refers to Sub-Saharan Africa; LAC is the Latin American and Caribbean region; and High-Income countries are the high-income members of the OECD.
source: The World Bank, *World Development Report*, 1997.

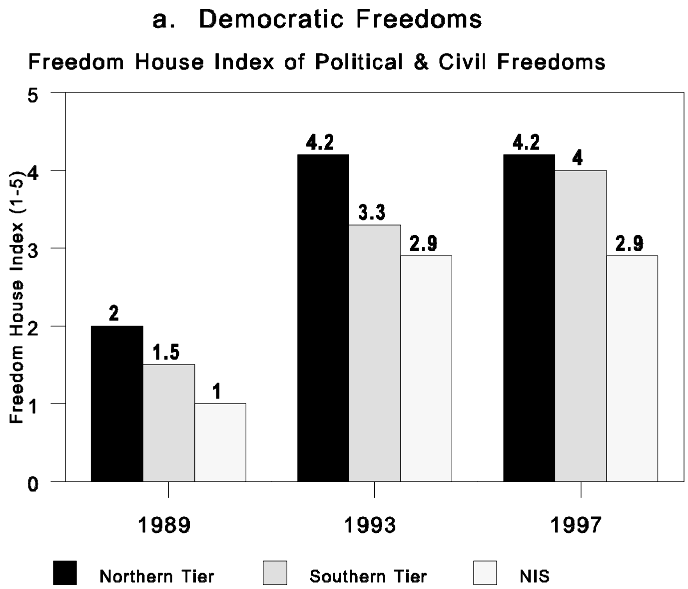
---

2. Comparisons Within the Transition Economies, Corruption Rating, 1998



note: Countries are rated for corruption on a scale of 1 to 4, with 1 being the least corrupt and 4 being the most corrupt.
source: Freedom House, *Nations in Transit*, 1998.

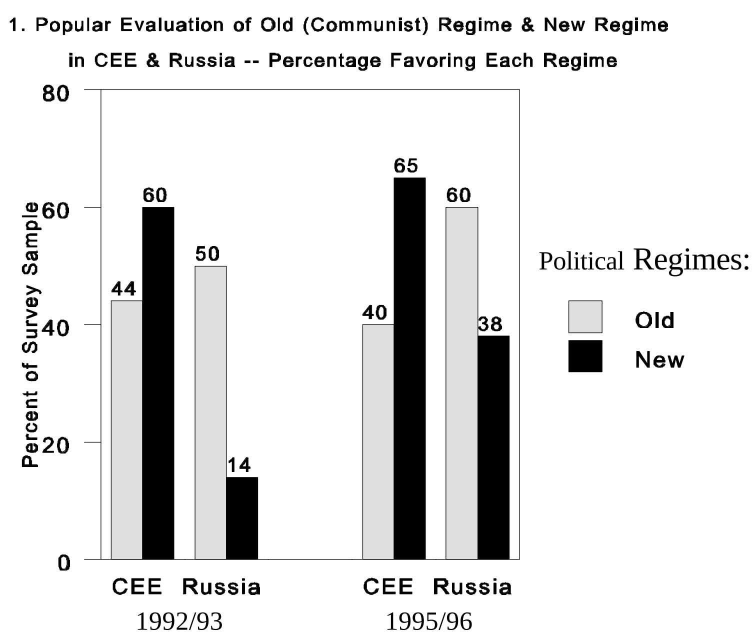
3. Democratization



note: Countries are rated for political freedom and civil liberties on a scale of 1 to 5, with 5 being the most free and 1 being the least free.
source: Freedom House, *Freedom in the World*, 1998 and earlier years.

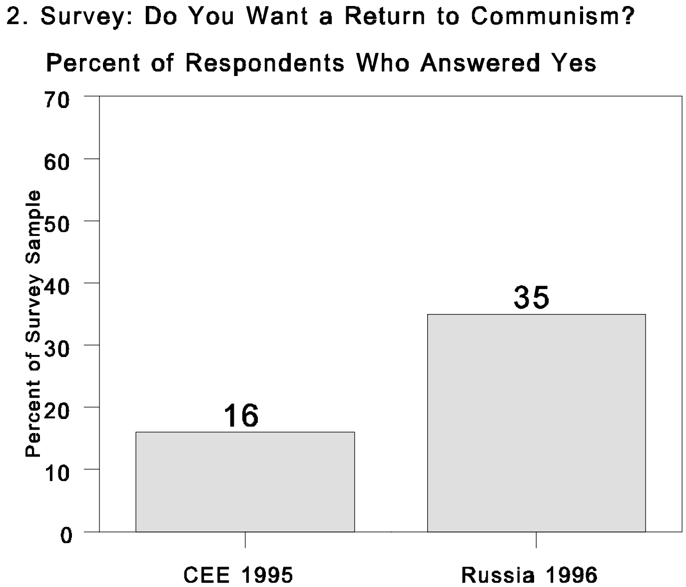
---

b. Perceptions



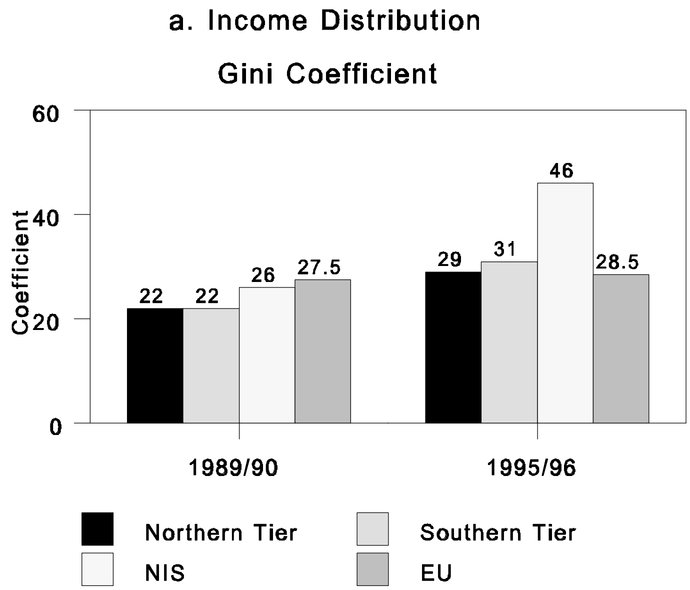
note: Based on nationwide surveys in the Czech Republic, Slovakia, Hungary, Poland, Slovenia, Bulgaria, Romania, and Russia.
source: Richard Rose, "Where are Post-Communist Countries Going: Public Opinion in New Democracies," *Journal of Democracy*, vol. 8, no. 3, July 1997.

3. Democratization
    b. Perceptions



source: Rose, *ibid.*

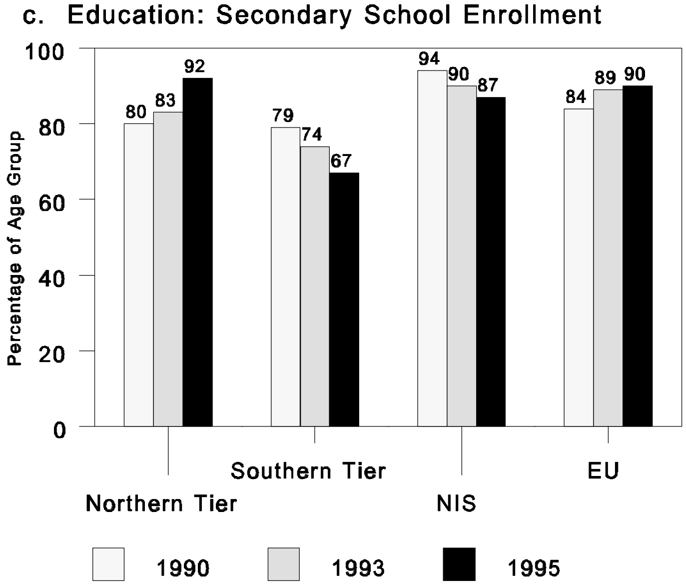
4. Social conditions



note: The Gini Coefficient ranges from zero to 100; the higher the number, the greater the inequality of income.
source: UNICEF, *Education for All?*, The MONEE Project, #5,1998.

note: The percent of the population in poverty are those below the poverty line of $120 per capita per month at 1990 international prices.
source: Branko Milanovic, *Income, Inequality, and Poverty During the Transition from Planned to Market Economy*, World Bank, 1998.

4. Social Conditions



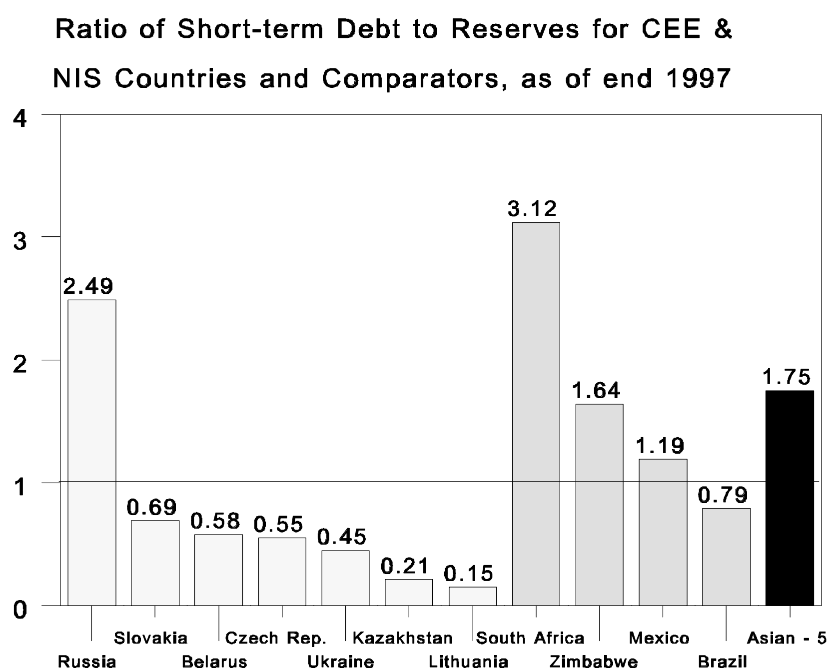
source: World Bank, *World Development Report* 1996; *World Development Indicators* 1998.

5. Effects from the Global Economic Crisis
   a. Trade Links to Russia

source: IMF, *Direction of Trade Statistics*, 1998, and *International Financial Statistics*, 1998.

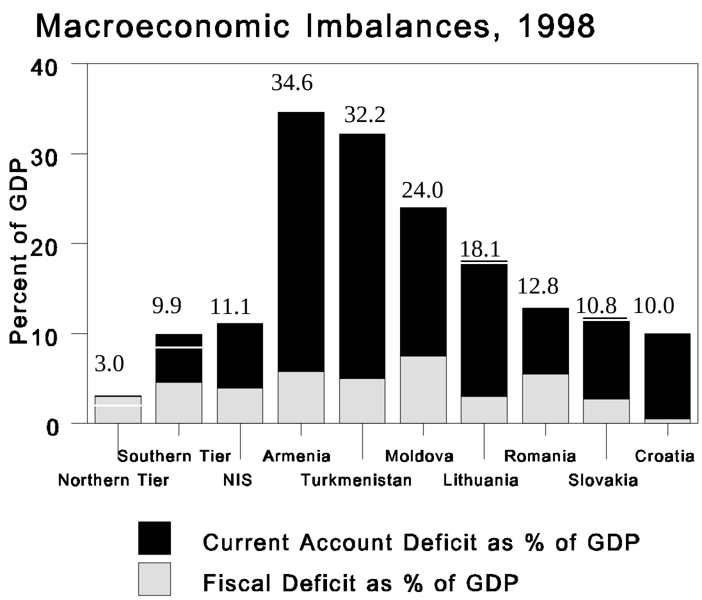
---

b. Debt & Reserves



note: Of the Asian - 5 (Indonesia, Korea, Malaysia, Philippines, and Thailand), only Malaysia had a ratio of short-term debt to reserves less than one by the end of 1997.
source: IMF, *IFS*, May 1998; Bank of International Settlements; S. Radelet & J. Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects," CAER II Discussion Paper No. 29, July 1998.

5. Effects from the Global Economic Crisis
    c. Risk of Contagion: Deficits and Debt Service



source: EBRD, *Transition Report*, 1998.

note: The adverse effects of high "twin deficits" are exacerbated when debt service is likewise high. For 1997, external debt service as a percentage of exports was:

Turkmenistan	35%	Moldova	17%
Lithuania	19%	Armenia	16%
Romania	18%	Croatia	12%
Slovakia	17%		